U.S. SECURITIES AND EXCHANGE COMMISSION
Admin. Proc. File No. 3-20127

In the Matter of the Application of :

ERIC S. SMITH :

For Review of Disciplinary Action Taken By :

FINRA :

APPLICANT ERIC S. SMITH'S OPENING BRIEF

TABLE OF CONTENTS

TABLE OF AUTHORITIES

INTRODUCTION

In 1938, after four years of consultations between the then-newly-created U.S. Securities and Exchange Commission ("SEC") and representatives of the securities industry, the United States Congress passed the Maloney Act, later described by the SEC as "a unique experiment in supervised self-regulation."[1] The Maloney Act created the opportunity for registered broker-dealers, including those that were not members of any securities exchanges, to establish a self-regulatory organization ("SRO") that would be subject to Federal supervision by the SEC. Within one year, the securities industry created the National Association of Securities Dealers, Inc. to serve as the SRO, with the power to adopt rules of conduct and bring disciplinary proceedings against NASD members for violating those rules of conduct, all under the statutorily mandated supervision of the SEC. The fundamental purpose of the Maloney Act was to empower an SRO for the securities industry to enforce conduct standards imposed by the SRO on members of the SRO with the full support and backing of the SEC. The Maloney Act also expressly granted to the SEC all of the duties and responsibilities to enforce the Federal securities laws and regulations that applied to registered broker-dealers and other persons who did not become members of the SRO. For the past 80 years, the SRO of the securities industry – now known as FINRA – has performed a vital role in both establishing conduct standards for the firms that *voluntarily* become FINRA members and enforcing those standards through disciplinary proceedings against FINRA member firms and the individuals who *voluntarily* register with and seek professional licenses from FINRA.

---

[1] T. Hed-Hofmann, *The Maloney Act Experiment*, 6 Boston College Industrial and Commercial Law Review 1987 (1965) (*quoting* SEC Report of Special Study of Securities Markets, H.R. Doc No. 95, 88th Cong. 1st Sess., pt. 5, at 188 (1963)).

Appellant Eric S. Smith is not one of those individuals who voluntarily registered with FINRA or sought a professional license from FINRA. Nor did he ever seek to become a member of FINRA. Nonetheless, in a clear abuse of its self-regulatory authority, those undisputed facts were disregarded and, in August 2017, FINRA's Department of Enforcement commenced an SRO disciplinary proceeding against Smith, alleging that he had: (a) engaged in securities fraud; and (b) violated FINRA rules by failing to register as either as a "general securities representative" or a "principal" of a FINRA member firm and obtain from FINRA the professional licenses required by FINRA for those registrations. Thus, in its own Complaint, FINRA's Department of Enforcement admitted that Smith had not voluntarily granted FINRA any jurisdiction to bring an SRO disciplinary proceeding against Smith.

In front of both the three-person FINRA Hearing Panel and the two-person committee of the National Adjudicatory Counsel ("NAC"), Smith objected to FINRA's assertion of disciplinary jurisdiction over him. Both the Hearing Panel and the NAC Panel rejected Smith's jurisdiction objection. Instead, the Hearing Panel and NAC decisions concluded, erroneously, that if Smith's business activities met FINRA's definition of "person associated with a member firm," then Smith was automatically subject to FINRA's SRO disciplinary jurisdiction. Neither the Hearing Panel nor the NAC Panel explained in their decisions how FINRA could assert SRO jurisdiction over an individual who was not a "member" of the SRO, had not voluntarily registered with the SRO, and had not voluntarily sought a professional license from the SRO.

On this appeal, Smith asks the SEC to exercise its supervisory authority over FINRA and reverse FINRA's unlawful assertion of SRO jurisdiction over him. The NAC decision against Smith, dated September 18, 2020 (the "NAC Decision"), must be vacated. The SEC should

further direct FINRA to never again institute an SRO disciplinary proceeding against any person who has not registered with FINRA or sought a professional license from FINRA.

In addition, the SEC must also reverse the determinations by the Hearing Panel and the NAC that Smith had violated the anti-fraud provisions of the Federal securities law and FINRA's rules. The relevant claims brought by FINRA's Department of Enforcement ("DOE") against Smith required proof that any misrepresentations in, or omissions from, communications concerning the sale of securities constituted "material" misrepresentations or omissions. But the DOE failed to introduce any witness testimony or documentary evidence concerning the "materiality" of the alleged misrepresentations and omissions. According to the DOE, both the Hearing Panel and the NAC Panel could conclude that the misrepresentations and the omissions were "material" based solely on the personal opinions of the three members of the Hearing Panel and the two members of the NAC Panel. Both the Hearing Panel and the NAC Panel followed DOE's lead and erroneously held that Smith engaged in securities fraud even though DOE had presented no evidence that any misrepresentations or omissions were "material."

Section 15A(b)(8) of the Exchange Act requires FINRA to provide a "fair procedure" for disciplinary proceedings brought against members and other persons who consent to FINRA disciplinary jurisdiction. 15 U.S.C. 78o-3(b)(8). The SEC has held that the DOE bears the burden of proof in a FINRA disciplinary action and must prove the alleged violations by a preponderance of the evidence. *See, e.g., David M. Levine*, 57 S.E.C. 50, 73 n.42 (2003). If DOE can meet its "burden of proof" concerning an allegation of securities fraud without introducing testimonial or documentary evidence concerning the "materiality" of the alleged misrepresentations or omissions, then the "preponderance of evidence" standard supposedly required in FINRA disciplinary proceedings is a sham and those proceedings necessarily violate

Section 15A(b)(8)'s "fair procedure" requirement. No "fair procedure" allows a FINRA Hearing Panel, or a NAC Panel, to substitute the personal opinions of the members of those panels for their duty to weigh the evidence actually received at a FINRA disciplinary hearing from both the DOE and charged respondent.

The failure to require DOE to present actual evidence of "materiality" in the FINRA disciplinary action against Smith was particularly egregious because Smith provided an enormous amount of financial and operational information – both positive and negative – concerning Consulting Services Support Corporation ("CSSC-Parent") when communicating with potential lenders during the relevant time period and that documentary evidence was submitted to the Hearing Panel. None of the four persons who made the $130,000 in loans that formed the basis for the FINRA securities fraud charges (the "Four Lenders") testified at the hearing concerning which pieces of information about CSSC-Parent were "important" to their investment decision. DOE provided no expert testimony concerning the "materiality" of the alleged misrepresentations and omission. None of the documents introduced into evidence, by themselves or cumulatively, satisfied DOE's burden to demonstrate that the alleged misrepresentations and omission substantially altered the "total mix of information" received by the Four Lenders and, therefore, were "material". In the absence of actual evidence of "materiality" presented by the DOE, neither the Hearing Panel nor the NAC was permitted to find that Smith had engaged in securities fraud because the DOE had not proven that required element by a *preponderance of the evidence*.

Finally, the DOE also failed to meet its burden of proof that Smith's business activities met the definition of "person associated with a member firm" set forth in FINRA's by-laws and rules. At all relevant times, Smith served as the Chairman and CEO of CSSC-Parent. All of

Smith's business activities were performed in that capacity, including communicating on behalf of CSSC-Parent with the Four Lenders and other persons who had loaned monies to CSSC-Parent during the period from 2010-2015. In addition, the evidence at the hearing showed that other persons managed the securities activities of CSSC Brokerage Services, Inc. ("CSSC-BD"), the FINRA member firm that was a subsidiary of CSSC-Parent.

As described further below, the SEC must reverse the NAC decision and dismiss this disciplinary proceeding.

FACTS

A. Background

In 1998, Smith formed Consulting Services Support Corporation ("CSSC-Parent"). FINRA Record on Appeal ("R.") 2163. The business of CSSC-Parent was to provide research, marketing, technology, and administrative services to independent professionals (such as attorneys and accountants) who provided investment advice to their clients. R. 2164-65. The services provided by CSSC-Parent did not require it to register with the U.S. Securities and Exchange Commission and CSSC-Parent did not become or seek to become a FINRA member firm at any time. At all relevant times, Smith served as Chairman and CEO of CSSC-Parent.

Shortly after its formation, CSSC-Parent created CSSC Investment Advisory Services, Inc. ("CSSC-RIA") to serve as the subsidiary through which the independent professionals would provide investment advisory services to individual clients of those professionals. R. 2164. In addition to investment advisory services provided through CSSC-RIA, insurance products were sold through a separate insurance subsidiary. R. 1808-09. In 2002, CSSC-RIA registered with the SEC under the Investment Advisors Act of 1940. R. 2164-65. CSSC-RIA never registered with the SEC as a broker-dealer and never became a FINRA member firm.

CSSC-Parent employed a core group of salaried employees at its offices in Troy, Michigan. R. 864-65. The independent professionals who provided investment advice, known within CSSC-Parent as "affiliates", were located throughout the country and received compensation from CSSC-RIA as independent contractors ("CSSC Affiliates") based upon the fees paid by clients for investment advisory services. *Id.* Each CSSC Affiliate executed a written agreement that described the terms and conditions of the services provided to the CSSC Affiliates by CSSC-Parent and its subsidiaries. R. 3579-610. CSSC Affiliates were required to become associated with CSSC-RIA but were not required to become registered with or licensed by FINRA. Although CSSC-Parent never required CSSC Affiliates to register with FINRA and become licensed representatives associated with a registered broker-dealer, many CSSC Affiliates did become associated with a broker-dealer so that they could receive commissions from sales of certain financial products. R. 1171, 3596.

Shortly after its formation, CSSC-Parent began researching how to provide to the investment advisory clients with an objective comparative analysis of investment choices that would be aligned with each client's needs, goals, and investment preferences. As a result of that effort, CSSC-Parent developed proprietary decision-assistance technology to score and rank thousands of available mutual funds and other potential investment vehicles based on weighted blends of multiple, client-specific investment criteria. CSSC Affiliates then used that decision technology-based scoring/ranking of potential investments to provide investment advice to clients. In 2010, CSSC-Parent received a U.S. patent for this technology. R. 2165.

From 1998 through the end of 2006, clients of CSSC-RIA maintained securities brokerage accounts at two different registered broker-dealers that were FINRA member firms. During that time period, when clients purchased mutual funds that charged sales commissions,

those broker-dealers received those sales commissions and shared those commissions with the CSSC Affiliates who had registered with FINRA and become associated with those FINRA member firms in addition to their association with CSSC-RIA.

B. Formation and Operation of a Registered Broker-Dealer

During the early 2000s, Smith identified an opportunity for CSSC-RIA to provide a financial benefit to its investment advisory clients. Specifically, Smith learned that while financial regulations prohibited registered representatives of broker-dealers from sharing or rebating commissions to clients, nothing would prohibit CSSC-RIA from reducing its investment advisory fees to its clients based upon brokerage commissions received by a broker-dealer subsidiary of CSSC-Parent. Based upon that insight, in 2006, Smith authorized a team of CSSC employees who were already licensed by FINRA (which did not include Smith) to form CSSC Brokerage Services, Inc. ("CSSC-BD") as a wholly owned subsidiary of CSSC-Parent.

In August 2006, CSSC-BD filed its Form BD with the SEC and its membership application with FINRA. R. 3699-796. The FINRA membership application filed by CSSC-BD affirmatively stated that Smith did not intend to obtain a FINRA principal license or any other FINRA license and described Smith's role as Chairman and CEO of CSSC-Parent, his ownership interest in CSSC-Parent, and CSSC-Parent's ownership of CSSC-BD. R. 3779. Smith signed this letter to FINRA after discussions with counsel and members of the CSSC-Parent team responsible for creating, registering, and then operating CSSC-BD and who had prepared the letter. Smith sincerely believed that the duties and responsibilities that he intended to fulfill, and thereafter did fulfill, as Chairman and CEO of CSSC-Parent would not and did not involve him in the securities business of CSSC-BD and, therefore, did not require any FINRA license. R. 840-41, 1171-72.

In November 2006, as part of the membership application process, CSSC-BD sent a memorandum to FINRA in which CSSC-BD again affirmatively stated that Smith did not intend to obtain a FINRA principal or broker's license and described Smith's duties and responsibilities as the Chairman and CEO of CSSC-Parent. R. 3797-98. In particular, CSSC-BD confirmed to FINRA that Smith would recruit CSSC Affiliates, all of whom would serve as CSSC-RIA representatives and many of whom would likely become registered representatives of CSSC-BD. R. 846-47, 3797-98. Fully consistent with those disclosures, Smith never became an officer, director, or employee of CSSC-BD; nor did he ever become a signatory on any CSSC-BD bank account. R. 2165-66.

In December 2006, FINRA approved the membership application of CSSC-BD. FINRA did not condition that approval on either: (a) requiring Smith to obtain any license; or (b) requiring CSSC-BD to identify Smith as a person associated with CSSC-BD in any capacity. R. 3799-801, 3803-04.

During 2007, FINRA conducted an on-site examination of CSSC-BD. At the conclusion of that examination, FINRA did not identify any licensing issue concerning Smith based upon the role played by Smith in connection with the operation of CSSC-BD. R. 3805-07. Similarly, during 2011, FINRA conducted another on-site examination and again found no license issues with the role played by Smith. R. 3809-11, 3813-16. As a result, Smith continued to perform his duties as Chairman and CEO of CSSC-Parent in the same manner as before and he took no steps to obtain a principal license from FINRA or otherwise register with FINRA.

Consistent with the business purpose behind its creation, at all relevant times, CSSC-BD's "securities business" was functioning as a trading platform for the investment advisory services provided to clients by CSSC-RIA and receiving commissions from issuers of investment

products, when such commissions were paid to broker-dealers. R. 1912-13, 2070-71. All of CSSC-BD clients' assets were custodied at the SEC-registered clearing firm retained by CSSC-BD for that purpose. The primary business of all CSSC-BD representatives was to provide investment advisory services to clients through CSSC-RIA, based on CSSC-Parent's decision-assistance technology. R. 1824-25.

Given the essentially administrative function of CSSC-BD' securities business (executing trades identified by CSSC-RIA representatives via the clearing firm and collecting commissions from issuers of mutual funds when available) and based on the representations made to FINRA in the membership application filed by CSSC-BD, there was no need for Smith to participate in CSSC-BD's securities business, much less in a management role, and he did not.

Instead, at all relevant times, CSSC-BD was managed by persons other than Smith, including Alex Martin ("Martin") and Jennifer LaRose ("LaRose"), who became the Co-Chief Executive Officers and Directors of CSSC-BD. R. 3733-35. Martin and LaRose supervised all broker-dealer activities engaged in by CSSC Affiliates. R. 1487-89, 1566-68, 2128-29. When CSSC Affiliates first signed written affiliation agreements, Martin or LaRose signed on behalf of CSSC-BD. R. 3591-92. Smith never functioned, in form or substance, as an officer, director or branch manager of CSSC-BD. For example, the only time that Smith participated in any FINRA examination of CSSC-BD was during 2015, when FINRA requested numerous documents concerning CSSC-Parent that were exclusively in the possession of CSSC-Parent. R. 2105-06.

C. Capital Raising Activities of CSSC-Parent: 2010-2014

Throughout its history, CSSC-Parent has raised funds, when necessary to finance its business operations, through the sale of common stock, bonds and promissory notes as well as ad hoc loans. By 2006-07, CSSC-Parent had achieved solid profitability based largely on

investment advisory fees earned by CSSC-RIA. However, the financial crisis of 2008-09 and the accompanying dramatic losses experienced in the financial markets caused a substantial drop in those fees, which were based on the amount of assets under management. R. 2377-82.

In 2010, CSSC-Parent privately offered $5 million in bonds for sale (the "2010 Bond Offering") by communicating directly with existing shareholders and other potential investors. R. 2899-3078. Based upon advice of legal counsel, Smith prohibited CSSC Affiliates from recommending the bonds to any of their investment advisory clients. The terms of the offering stated that no commissions would be paid with regard to the placement or sale of the Bonds. Thus, there was no compensation that could be earned by CSSC Affiliates, including registered representatives of CSSC-BD in connection with any such bond sales. R. 2899. Instead, Smith informed the CSSC Affiliates that if they knew someone who might be interested in purchasing a bond from CSSC-Parent, they could tell that person to contact Smith, who would then provide the offering memorandum and subscription documents directly to the potential purchaser on behalf of CSSC-Parent. R. 1824-26. Smith received no commissions from CSSC-Parent as a result of any bond purchases.

The subscription documents for the 2010 Bond Offering required the potential purchasers to disclose personal and financial information. R. 3064-68. Smith and other CSSC-Parent employees reviewed those questionnaires to make sure that the sales of the bonds by CSSC-Parent fully complied with all securities regulations governing the private sale of securities and the conditions that CSSC-Parent had set for bond purchasers. R. 852-53, 1035-36, 2937-39.

During 2010-2014, CSSC-Parent and Smith sought to develop potential new streams of revenue based on its patented decision-assistance technology while continuing to attempt to recruit new CSSC-Affiliates and thereby expand the investment advisory fee revenues received

by CSSC-RIA. During 2014, Smith determined that CSSC-Parent should raise additional funds through the sale of Bridge Loan Notes (the "2014 Bridge Loan Note Offering"). As with the 2010 Bond Offering, the CSSC Affiliates were prohibited from recommending the purchase of the notes to their investment advisory clients and none received any compensation in connection with the 2014 Bridge Loan Notes. Smith communicated directly with potential purchasers on behalf of CSSC-Parent, the entity seeking the loans. R. 1479-80.

D. The 2015 Bridge Loan Note Offering by CSSC-Parent

By June 2015, Smith determined that CSSC-Parent required additional financing to achieve its goal of re-establishing profitability through new revenue streams as well as increased investment advisory fee revenues through CSSC-RIA. At that time, Smith prepared a package of documents that he sent to potential lenders (the "2015 Bridge Loan Note Offering"). These documents included: (i) a summary memorandum drafted by Smith; (ii) the substance of a presentation made in May 2015 at a CSSC-Parent shareholders meeting by multiple CSSC-Parent employees; and (iii) CSSC-Parent financial statements (the "2015 Offering Documents"). R. 2744-849. Consistent with the 2010 Bond Offering and the 2014 Bridge Loan Note Offering, none of the CSSC Affiliates recommended the purchase of any 2015 Bridge Loan Notes to their advisory clients and, instead, Smith communicated directly with potential purchasers on behalf of CSSC-Parent.

The 2015 Offering Documents contained robust disclosures concerning the numerous pros and cons of loaning monies to CSSC-Parent in mid-2015. These disclosures included descriptions of potential new revenue streams that were being pursued by CSSC-Parent, nearly all of which were based on the patented decision-assistance technology. These potential revenue streams included: (a) new insurance business initiatives; (b) licensing of the technology to non-

financial services uses, such as fantasy sports businesses; (c) marketing of the technology through a new CSSC Affiliate to financial services firms for use in compliance programs; (d) a special purpose bank project known internally at CSSC-Parent as Project X, then managed by Donald Southwick ("Southwick"); (e) a developing relationship with South Dakota Trust Company; and (f) a new business relationship with the City of Jacksonville, Florida (a former CSSC-RIA investment advisory client) concerning its short-term operating funds as well as its pension assets. R. 2384-97. In addition to potential new revenue streams, the 2015 Offering Documents also described the existing revenues of CSSC-RIA and CSSC-BD as well as the potential for raising capital to retire all debt, including the bridge loan notes, through an equity offering. R. 2382-83, 2394, 2396-97.

At the same time that the 2015 Offering Documents described the potential positive aspects of purchasing a note, the 2015 Offering Documents provided stark warnings concerning CSSC-Parent's historic and current financial losses, including its then-current inability to pay its debts from operating revenues. R. 2377-82. Specifically, the 2015 Offering Documents disclosed that CSSC-Parent had lost more than $1 million in 2014 and that was the 6th year in a row that CSSC-Parent has lost money. CSSC-Parent further stated:

> Until this restructuring is completed and the additional capital investments are secured, and until the Company passes back over into sustainable profitability, the Company is currently covering its operating deficits through a short-term 'Bridge Loan' offering.

R. 2378. CSSC-Parent further stated that the only way that it had been able to pay its operating expenses deficits during 2014-2015 was through monies raised from the 2014 Bridge Loan Note Offering. R. 2746. The 2015 Offering Documents also stated that the operating deficits had caused CSSC-Parent to be late on payments to CSSC Affiliates and that had caused CSSC-Parent to lose some of the CSSC Affiliates, thereby lowering revenues. R. 2746-48, 2750. Based on all

of this negative financial information fully disclosed by CSSC-Parent, the 2015 Offering Documents also included the following grim warning:

> Making an unsecured loan to a company that is experiencing current cash flow shortfalls involves a significant amount of risk. And, while 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, there is no guarantee that that will be the case or that the loan will be repaid, with interest, when due. Loans of this type should be made only by those financially able and willing to accept the risk that all or part of the loan amount could be lost. If you are a CSSC Investment Advisory Services, Inc. and/or a CSSC Brokerage Services, Inc. client, no recommendation or advice is being offered regarding whether or not to make such a loan.

R. 2308.

Each of the Four Lenders received copies of the 2015 Offering Documents from Smith prior to lending the $130,000 to CSSC-Parent. In addition, Smith personally communicated with each of the Four Lenders via telephone and email while they were deciding whether or not to loan monies to CSSC-Parent. R. 2170-73 (TL), 2174-76 (Scotto), 2177-81 (BB), 2182-84 (Clarkson). In the written communications with Smith concerning their loans, none of the Four Lenders specifically identified which pieces of information in the 2015 Offering Documents had been relevant or important to their decision to loan monies to CSSC-Parent at that time.

E. The FINRA Disciplinary Proceeding

1. The DOE Complaint

On August 4, 2017, the DOE issued a complaint against Smith and CSSC-BD. [R 00001-05.] The Complaint alleged that Smith made the following misrepresentations and omissions when communicating with the Four Lenders in 2015: (a) failing to disclose that CSSC-Parent could not make interest payments to existing bondholders and investors without raising additional capital; (b) failing to disclose that in May 2015, CSSC-Parent was "in default to existing bondholders and investors" and unable to repay more than $3 million that "would

eventually become due"; (c) misrepresenting that CSSC-Parent "had earned, was receiving and would continue to receive millions of dollars in revenue" from the special purpose bank project known as Project X; (d) "touting" a future "revenue event" arising from a business relationship between CSSC-Parent and South Dakota Trust Company; and (e) misrepresenting the business relationship between CSSC-Parent and the City of Jacksonville and that "significant revenue" would be received in the future as a result of that relationship. R. 007, ¶ 3. The Complaint further alleged that, as a result of certain business activities undertaken by Smith, he violated NASD Rules 1021 and 1031 by failing to register with FINRA as both a general securities representative and a principal of CSSC-BD. R. 008, ¶ 6.

With respect to FINRA's jurisdiction over Smith, the Complaint admitted that Smith had never registered with FINRA and never held any securities licenses issued by FINRA. R. 009, ¶¶ 14-15. The Complaint falsely stated that Smith was the majority owner of CSSC-BD and that Smith signed Affiliate Agreements on behalf of CSSC-BD. *Id.*, ¶ 15. The Complaint further alleged that Smith "controls all aspects of [CSSC-BD's] business", "regularly making the decisions to hire and fire Affiliates, and supervising the securities activity of [CSSC-BD's] registered representatives." *Id.* According to the Complaint, "[b]y virtue of Smith's current association with and duties on behalf of [CSSC-BD], FINRA has jurisdiction over Smith under Article XIII of its By-Laws." *Id.*, ¶ 17. The Complaint did not attempt to explain how Smith, who was <u>not</u> a FINRA member and had never registered with FINRA or received any licenses from FINRA, had magically become subject to FINRA's By-Laws in the absence of any legal relationship with FINRA.

2. The Hearing

In response to the DOE Complaint, Smith filed an Answer in which, *inter alia*, he denied that FINRA had any jurisdiction over him. R. 076 (¶ 17), 123 (Tenth Affirmative Defense.) Despite Smith objection to FINRA jurisdiction, FINRA appointed a Hearing Panel and an 8-day disciplinary hearing was held from June 18, 2018 through June 27, 2018. R. 783 – 2292.

During the Hearing, DOE did not seek to introduce any evidence concerning the "materiality" of the alleged omissions and misrepresentations that formed the bases for the fraud charges against Smith. Although DOE had issued a Rule 8210 demand to one of the Four Lenders – Thomas Scotto – to appear for testimony at the Hearing [R. 725, 729], DOE did not call Mr. Scotto as a witness and elicit testimony from him concerning the "materiality" of the alleged omissions and misrepresentations. Nor did DOE call any expert witnesses to testify about the "materiality" of the alleged omissions and misrepresentations.

No documentary evidence was introduced that, prior to loaning monies to CSSC-Parent, any of the Four Lenders asked any questions or made any comments concerning Project X or any of the other potential new revenue streams that DOE alleged were the subject of misrepresentations by Smith in the 2015 Offering Documents. Nor were any documents introduced into evidence in which any of the Four Lenders express any misunderstanding or confusion regarding the fact that CSSC-Parent was then unable to meet its debts as they came due without raising additional funds through debt offerings, including the very loans made by the Four Lenders. In fact, in an email at the end of August 2015, Scotto noted that he was then loaning $20,000 to CSSC-Parent at that time even though a prior loan from him had not been repaid by CSSC-Parent in May 2015. R. 897-902, 3361.

3. The Hearing Panel Decision

On January 2, 2019, the Hearing Panel issued its decision, erroneously finding: (a) FINRA had jurisdiction over Smith; (b) DOE had established by a preponderance of the evidence that Smith had violated the anti-fraud provisions of the Federal securities laws when the Four Lenders advanced $130,000 to CSSC-Parent in 2015; and (c) Smith had been required to register with FINRA and obtain professional licenses to act as both a securities representative and principal of CSSC-BD. R. 004252-63. The Hearing Panel imposed the following sanctions against Smith: (a) a permanent bar against association with any member firm; (b) an order of restitution, requiring Smith to personally repay the $130,000 in loans, plus interest, that the Four Lenders had made to CSSC-Parent; and (c) the costs of the disciplinary proceeding. R. 004268-69.

4. The NAC Decision

On September 18, 2020, the NAC Decision was issued by FINRA. The NAC Decision affirmed the Hearing Panel's liability findings as well as the sanctions of a permanent bar from association with a member firm and the restitution order. R. 004494.

ARGUMENT

I.

FINRA'S DISCIPLINARY PROCEEDING MUST BE DISMISSED BECAUSE FINRA NEVER HAD JURISDICTION TO INSTITUTE SUCH A PROCEEDING AGAINST SMITH

To find that FINRA had jurisdiction to bring a disciplinary proceeding against Smith, the NAC Decision relied on Articles I (rr), V and XIII of the FINRA By-Laws. R. 004518. Article I (rr) defines a "person associated with a member." Articles V and XIII authorize the institution of disciplinary proceedings and imposition of "appropriate sanctions" on "persons associated with members" for violations by such persons of the Federal securities laws or FINRA rules.

FINRA is a Delaware corporation. Section 109(b) of the Delaware Corporation Code states, in relevant part:

> (b) The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and *its rights or powers or the rights or powers of its stockholders, directors, officers or employees*.

Delaware Statutes, Title 8, § 109(b) (emphasis added).[2] Thus, the bylaws of a Delaware corporation simply cannot govern the relationship between the corporation and any person who is not a stockholder/member, director, officer or employee of that corporation.[3]

---

[2] Section 114(a)(1) of the Delaware Corporation Code states that Section 109(b) applies to nonstock corporations and, for such corporations, "all references to stockholders of the corporation shall deemed to refer to members of the corporation."

[3] In addition to relying on provisions of FINRA's bylaws, the NAC Decision cites three SEC decisions involving FINRA disciplinary actions against individuals as support for FINRA's assertion of jurisdiction over Smith. *Louis Ottimo*, Exchange Act Release No. 83555 (June 28, 2018); *Stephen Grivas*, Exchange Act Release No. 77470 (March 29, 2016); *Keilen Dimone Wiley*, Exchange Act Release No. 76558 (December 4, 2015), *aff'd*, 663 F. App'x 353 (5th Cir. 2016). Each of those FINRA disciplinary actions concerned individuals who, unlike Smith, affirmatively registered with FINRA and obtained professional licenses from FINRA. *See* https://brokercheck.finra.org/individual/summary/2606438 (Louis Ottimo);

FINRA's own registration application procedures recognize that, absent the consent of an individual who is not a member firm, FINRA does not have any legal authority over that individual. FINRA requires every individual who applies to register with FINRA and obtain a professional license from FINRA to fill out and submit a Form U4. https://www.finra.org/sites/default/files/form-u4.pdf; FINRA By-Laws, Article V, Section 2. The Form U4 requires disclosure of information concerning the person registering with FINRA. Section 15A of the Form U4 contains a series of written representations that must be made by the person registering with FINRA. Paragraph 2 of Section 15A states:

> I apply for registration with the jurisdictions and SROs indicated in Section 4 (SRO REGISTRATION) and Section 5 (JURISDICTION REGISTRATION) as may be amended from time to time and, in consideration of the jurisdictions and SROs receiving and considering my application, *I submit to the authority of the jurisdictions and SROs* and agree to comply with all provisions, conditions and covenants of the statutes, constitutions, certificates of incorporation, by-laws and rules and regulations of the jurisdictions and SROs as they are or may be adopted, or amended from time to time. I further agree to be subject to and comply with all requirements, rulings, orders, directives and decisions of, and penalties, prohibitions and limitations imposed by the jurisdictions and SROs, subject to right of appeal or review as provided by law. [emphasis added]

Smith never filled out and submitted a Form U4 to FINRA, or otherwise consented to the "authority" of FINRA, or agreed to comply with FINRA's by-laws. In fact, as described above, when CSSC-BD first registered with the SEC as a broker-dealer and applied to become a FINRA member firm, both CSSC-BD and Smith specifically informed FINRA that Smith would not register with FINRA. At that time, FINRA could have rejected CSSC-BD's application to become a member firm unless Smith registered with FINRA. No such condition was ever imposed on CSSC-BD's FINRA membership.

---

https://brokercheck.finra.org/individual/summary/1829703 (Stephen Grivas);
https://brokercheck.finra.org/individual/summary/4259612 (Keilen Dimone Wiley).

Nothing in the Maloney Act or any later amendments to Section 15A of the Exchange Act provides FINRA with legal authority over an individual who has not voluntarily registered with FINRA and submitted to FINRA jurisdiction. While Section 15A of the Exchange Act requires that the rules of any securities industry SRO must "provide that . . . any person *may* become associated with a member thereof" (emphasis added), 15 78o-3(b)(3) nothing in the Exchange Act authorizes FINRA to bring a disciplinary action against an individual who has not *voluntarily* registered with FINRA. *See Padgett v. Dapelo*, 791 F. Supp. 438, 441 (S.D.N.Y. 1992) (Court rejected member firm challenge to arbitration award, stating "[p]etitioners entered the securities business and accepted the burdens of NASD membership *voluntarily*. If they did not wish to abide by the rules of the NASD, they easily could have avoided such rules by not joining the association.") (emphasis added), *aff'd*, 992 F.2d 320 (2d Cir. 1993).

When the Maloney Act's "unique experiment in supervised self-regulation" commenced in 1938, it was emphasized that the securities industry SRO would be a purely voluntary organization, albeit with financial incentives for broker-dealers to join the to-be-created SRO. In October 1938, SEC Commissioner George C. Mathews gave a speech that described the differences between the National Industrial Recovery Act ("NIRA") code that had been enacted for the securities industry (prior to the U.S. Supreme Court's declaration that NIRA violated the U.S. Constitution) and the securities industry SRO to be formed under the Maloney Act:

> Under the National Industrial Recovery Act, the Code, once it had been approved by the President, became the law of the land with respect to transactions in or affecting interstate commerce. *Everyone conducting an investment banking business, as defined in the Code, was bound by its provisions, irrespective of whether he assented thereto.* . . . Any violation of the provisions of the Code rendered the violator liable to injunction or prosecution. And in the case of a registered investment banker, violations were punishable by the Code Committee which was empowered to impose fines, and to suspend or cancel registration. From any such action by the Code Committee an aggrieved party might appeal to

> the Administrator. No machinery, however, was provided in the N.I.R.A. for judicial review of such proceedings.
>
> In definite contrast to the N.I.R.A. and the Code is the form of organization provided for in the Maloney Act. No broker or dealer is deprived of the use of the mails or of the channels of interstate commerce should he fail to join some registered securities association. *Nor is a broker or dealer bound by the rules of an association of which he is not a member.* The Act provides for the punishment by associations of members who disobey their rules and for the exclusion of brokers and dealers for specified offenses. [emphasis added.]

George C. Mathews, Commissioner, U.S. Sec. and Exch. Comm'n, Address at the Annual Convention of the Investment Bankers Association of America: A Discussion of the Maloney Act Program (Oct. 23, 1938), https://www.sec.gov/news/speech/1938/102338.mathews.pdf.

Similarly, a legal commentator noted at that time:

> [T]he Maloney Act consists of two basic provisions. First, it provides for the creation of *voluntary* self-regulatory associations of investment bankers, brokers and dealers with powers to adopt rules and regulations and to enforce them with effective economic sanctions. Secondly, *it grants to the Commission certain residuary powers over the entire over-the-counter industry, whether connected with the voluntary associations or not.* [emphasis added.]

Over-The-Counter Trading and the Maloney Act, 48 Yale Law Journal 633, 634 (1938).

By instituting a disciplinary proceeding against Smith despite the fact that Smith never voluntarily registered with FINRA and never submitted to its jurisdiction, FINRA acted beyond its legal authority as a Delaware corporation and an SEC-registered SRO. The only regulator that possessed any legal authority to bring any enforcement proceeding against Smith was the SEC, based on its Federal statutory authority to commence enforcement actions against anyone who violates the Federal securities laws. As FINRA's required Federal supervisor, the SEC must vacate the NAC Decision on the ground that FINRA never obtained SRO jurisdiction over Smith to commence such a proceeding.

II.

DOE FAILED TO PROVE THE MATERIALITY OF THE CHARGED MISREPRESENTATIONS AND OMISSIONS

Each of the fraud charges brought by DOE against Smith required DOE to prove by a preponderance of the evidence that the charged misrepresentations and omissions were "material." The NAC Decision acknowledged that DOE was required to prove that, with respect to the alleged misrepresentations and omissions,

> "[T]here 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."

R. 004510 (*quoting Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (*quoting TSC Indus., Inc. v. Northway, Inc.*, 425 U.S. 438, 449 (1976)).

After quoting the correct legal standard for proof of "materiality", the NAC Decision then failed to cite any evidence presented by DOE in support of a finding of "materiality" other than the 2015 Offering Documents themselves. R. 004510 – 4513. By failing to require DOE to present actual evidence of "materiality", the NAC Decision effectively eliminated the legal requirement that DOE prove all the elements of its claims "by a preponderance of *the evidence*."

Here, the total mix of information presented in the 2015 Offering Documents precluded any finding, as a matter of law, that the alleged misrepresentations and omissions were "material" to a reasonable investor. With respect to the charged omission – CSSC-Parent's failure to pay certain specific debt obligations in May 2015 – the 2015 Offering Documents plainly disclosed that CSSC-Parent had not been able to meet its financial obligations, had lost more than $1 million the prior year and was seeking to raise funds in order to continue to attempt to meet its financial obligations but could not guarantee that it would be able to do so. R. 2308, 2387-97. In the absence of actual evidence, it is pure speculation whether or not an additional

disclosure in the 2015 Offering Documents concerning the failure to pay certain specific debts would have *significantly* altered the "total mix" of information.

Similarly, the materiality of the alleged misrepresentations concerning CSSC-Parent's potential revenue streams could not be determined as a matter of law. The 2015 Offering Documents made a number of projections regarding future revenues, estimated the value of CSSC-Parent's patented technology, and described how CSSC-Parent hoped to expand its revenues from CSSC-RIA. R. 2387-2397. The 2015 Offering Documents also disclosed that CSSC-Parent had been trying for years (unsuccessfully) to generate new revenue streams. R. 2377-2382. Again, in the absence of actual evidence, it is pure speculation whether or not the alleged misrepresentations regarding specific revenue streams, such as Project X, would have significantly altered the total mix of information.

While there is no dispute that the materiality standard is "objective" and FINRA's claim did not require proof of reliance by any actual investors, DOE was still required to present sufficient, actual evidence of "materiality" to satisfy its burden of proof regarding the securities fraud charges against Smith. If one of the Four Lenders had testified that any of the alleged misrepresentations and omissions had been "important" in their investment decision-making process, that might have constituted sufficient evidence of materiality. But none of the Four Lenders provided any such testimony at the Hearing. Nor did DOE introduce circumstantial evidence concerning materiality from other fact witnesses at the hearing. DOE also had the opportunity to present expert testimony concerning the materiality of the charged omission and misrepresentations, taking into account all the facts and circumstances that existed in mid-2015 regarding CSSC-Parent and the total mix of information provided in the 2015 Offering Documents. But no such expert testimony was offered.

The NAC Decision erroneously concluded that DOE was not required to present any actual evidence of "materiality." R. 4510 – 4513. According to the NAC Decision, any misrepresentation or omission concerning the financial condition or revenues of an issuer of securities is *per se* "material." R. 4511. Worse, the NAC Decision also summarily dismissed the potential impact of all the negative financial and operational information disclosed in the 2015 Offering Documents on the question of "materiality", including arbitrarily describing certain negative information in the 2015 Offering Documents as "boilerplate." R. 4512-13. No part of the NAC Decision's discussion of "materiality" was based on actual evidence introduced by DOE at the Hearing because no such evidence was presented by DOE during the Hearing.

Neither the DOE's arguments at the Hearing nor the opinions expressed by the Hearing Panel in its decision or in the NAC Decision now on appeal to the SEC constitute *evidence* of "materiality." The SEC must vacate the NAC Decision because its conclusion that Smith engaged in securities fraud was not proven by DOE by a preponderance of the evidence.

III.

DOE FAILED TO PROVE THAT SMITH VIOLATED FINRA'S REGISTRATION AND LICENSING RULES

Article I, paragraph (rr) of FINRA's By-Laws defines "person associated with a member" as:

> (1) a natural person who is registered or has applied for registration under the Rules of the Corporation; (2) a sole proprietor, partner, officer, director, or branch manager of a member, or other natural person occupying a similar status or performing similar functions, or 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 with the Corporation under these By-Laws or the Rules of the Corporation; and (3) for purposes of Rule 8210, any other person listed in Schedule A of Form BD of a member; . . . [emphasis added].

Article I, paragraph (u) of the By-Laws defines "investment banking or securities business" as:

> The business, carried on by a broker, dealer or municipal securities dealer . . . of underwriting or distributing issues of securities, or of purchasing securities and offering for same for sale as a dealer, or purchasing and selling securities *upon the order and for the account of others*. [emphasis added].

The NAC Decision found that Smith "acknowledged" that he was a "person associated with a member firm" when Smith signed a letter that referenced NASD Rule 1060 in August 2005 as part of CSSC-BD's membership application. R. 004518-19. That letter notified FINRA that Smith did not intend to register with FINRA in any capacity and thereby did not intend to subject himself to FINRA jurisdiction. Moreover, Smith attempted to submit additional documentary evidence concerning the August 2005 letter, which demonstrated that the August 2005 letter signed by Smith was a form letter drafted by the NASD and forwarded to CSSC-BD's Staff to give to Smith for his signature. R. 4133-47. Neither the NASD form nor the CSSC-BD Staff who forwarded the form letter to Smith disclosed to Smith that execution of the letter could be construed by FINRA to constitute an "acknowledgment" by Smith that he was a "person associated with a member firm." In fact, prior to the Hearing in this action, FINRA never took the position that the letter contained any such acknowledgement because Smith was never listed as an "associated person" on Schedule A of CSSC-BD's Form BD or in any amended application for FINRA membership after the date of the letter.

The NAC Decision also found that Smith "participated in [CSSC-BD's] securities business" when he raised funds for CSSC-Parent by directly communicating with potential investors in the direct, private offerings made by CSSC-Parent. R. 004519. Contrary to the NAC Decision, the fact that some of the purchasers of securities from CSSC-Parent also maintained accounts at CSSC-BD is not evidence that Smith was acting on behalf of CSSC-BD when he communicated with purchasers of CSSC-Parent securities in his role as Chairman and CEO of CSSC-Parent. Nor does the fact that CSSC Affiliates identified potential investors to Smith mean

that Smith's activities involving sales of CSSC-Parent securities were transformed into securities brokerage activities on behalf of CSSC-BD, rather than the direct sales of securities by an issuer, CSSC-Parent. Each of the CSSC Affiliates who were registered representatives associated with CSSC-BD were also investor advisor representatives of CSSC-RIA. Because Smith never sold securities in an intermediary capacity – on behalf of others – but, instead, sold securities on behalf of CSSC-Parent in his capacity as Chairman and CEO of CSSC-Parent, Smith never "participated in the securities business" of CSSC-BD.

Finally, the NAC Decision also erroneously found that Smith "actively engaged in the management of CSSC-BD's securities business, which required Smith to register as a principal." R. 004521. The NAC Decision based this conclusion on the activities that Smith engaged in as Chairman and CEO of CSSC-Parent. R. 004521-23. The fact that Smith recruited and hired CSSC Affiliates did not constitute proof of his involvement in CSSC-BD's *securities business* because the principal business of all CSSC Affiliates was providing investment advisory services through CSSC-RIA. The evidence presented at the Hearing demonstrated that CSSC-BD's *securities business* consisted almost exclusively of executing trades (through its clearing firm) in securities recommended by CSSC-RIA investment advisor representatives and collecting brokerage commissions when available, which were then used, in part, to reduce the investment advisory fees of the CSSC-RIA clients. No evidence was presented that Smith played any supervisory role with respect to that trade execution and commission collection activity. Instead, solely in his role as Chairman and CEO of CSSC-Parent, Smith actively monitored CSSC-BD's financial condition and provided parent company oversight of a subsidiary company's executives who exercised responsibility for managing the securities business of CSSC-BD.

CONCLUSION

For the foregoing reasons and based upon the entire evidentiary record in this proceeding, the NAC Decision should be vacated and the disciplinary proceeding against Eric S. Smith dismissed.

Dated: New York, New York
January 18, 2021

SHER TREMONTE LLP

By: 

Robert Knuts

90 Broad Street, 23rd Floor
New York, New York 10004
Tel: 212.202.2638
rknuts@shertremonte.com

Attorneys for Respondent Eric S. Smith