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**IN THE UNITED STATES DISTRICT COURT
DISTRICT OF UTAH, CENTRAL DIVISION**

SECURITIES AND EXCHANGE COMMISSION,

PLAINTIFF,

v.

**MEMORANDUM IN
SUPPORT OF MOTION
FOR TEMPORARY
RESTRAINING ORDER,
EX PARTE ASSET
FREEZE, APPOINTMENT
OF A RECEIVER AND
OTHER RELIEF**

BRIAN J. SMART, and
SMART ASSET, LLC, a California limited liability
company,

DEFENDANTS.

Case: 2:09-cv-00224
Assigned To : Kimball, Dale A.
Assign. Date : 03/11/2009
Description: USA & SEC v. Smart, et al

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Plaintiff, Securities and Exchange Commission (the “Commission”), respectfully submits this Memorandum in Support of Its Motion for Temporary Restraining Order, Ex Parte Asset Freeze, Appointment of a Receiver and Other Relief. The Commission seeks this emergency relief to protect its ability to recover some of the millions of dollars misappropriated by Defendants in a brazen scheme which defrauded investors out of over \$1.68 million dollars. The Commission respectfully requests this Court to enter a temporary restraining order against Defendants to temporarily enjoin them from further violations of the federal securities laws. In addition, the Commission requests the Court to enter an Order freezing Defendants’ assets, expediting discovery and preventing the destruction of documents. Finally, the Commission requests that the Court enter an Order appointing a Receiver over defendant Smart Assets LLC in order to marshal and preserve assets for eventual distribution to investors or other parties with legitimate claims.

STATEMENT OF FACTS

PARTIES

Brian J. Smart (“Smart”), age 32, is a resident of Lehi, Utah. See Declaration of Brian T. Fitzsimons (“Fitzsimons Decl.”) at ¶ 7. **Smart Assets, LLC** (“Smart Assets”) is a California limited liability company. Smart Assets conducts business throughout the State of Utah. See Fitzsimons Decl. ¶ 6. Smart, and his spouse, Kelli R. Smart, are believed to be the only members of Smart Assets and manages Smart Assets through various locations within Utah, including the Smart’s residence in Lehi, Utah and offices in Salt Lake City, Utah. See Fitzsimons Decl. ¶ 6-7.

BACKGROUND

Since at least 2003, Smart, through his entity, Smart Assets, has misappropriated at least \$1.68 million of investors' funds in what is likely a Ponzi-like scheme through the use of misstatements and omissions. It appears that Smart's fraudulent scheme has developed through three phases. In phase one, Smart solicited client money by holding himself out as a "financial planner." See Fitzsimons Decl. ¶ 8. In phase two of his scheme, Smart, still holding himself out as a financial planner, issued promissory notes to investors paying a fixed rate of return ranging from 8.5 % per year to 18% per year. See Fitzsimons Decl. ¶ 8. Finally, in Phase 3 of the scheme, Smart, representing himself as a "hard money" real estate lender, issued promissory notes paying fixed rates of return ranging from 15% per year to 10% per month. See Fitzsimons Decl. ¶ 8. In all phases of his scheme, Smart assured investors that their money would be invested in safe and secure, principal guaranteed investments. Smart also distributed promotional materials that contained statements such as "[c]lients can realize above average returns without risking loss of principal" and that the investment is "[d]esigned for clients primarily interested in fixed rate strategy." See Fitzsimons Decl. ¶ 29. In reality, investors' monies were likely put into risky real estate deals, used for Smart's personal use, and paid out to previous investors in the form of dividends. See Fitzsimons Decl. ¶ 9.¹

Phase I

Beginning in 2003, Smart convinced Katherine Logan-Brown ("Brown") and Lisa Maria Padilla ("Padilla") to liquidate their annuity investments and invest all remaining

¹ Smart has not cooperated with the Commission's investigation and only agreed to speak with the Commission's staff after receiving a subpoena for testimony. Smart has also not complied with the Commission's investigatory document subpoena. At testimony, on the advice of counsel, Smart refused to answer questions based on a general assertion of his rights under the Fifth Amendment to the Constitution. Smart and his counsel refused to identify on what provision of the Fifth Amendment he was relying, despite requests for clarification whether he was invoking his right not to be compelled to testify. His counsel refused to clarify and indicated that the staff would receive the same response to similar questions.

money – including life insurance proceeds and trust assets – in purportedly low risk, principal guarantee mutual funds and other securities. See Fitzsimons Decl. ¶ 9. Smart assured investors that their principal would be secure and that they would have access to their money for living expenses, including nursing home fees, healthcare costs, and costs associated with the care of sick relatives. See Fitzsimons Decl. ¶ 9. Instead, it appears that Smart misappropriated Brown’s and Padilla’s funds, used the money for his own personal use, and invested in various risky business ventures, including real estate and commercial “hard lending.” See Fitzsimons Decl. ¶ 9.

Brown invested \$325,000 with Smart. See Fitzsimons Decl. ¶ 20. Smart was referred to Brown by AARP as a financial planning specialist for senior citizens. See Fitzsimons Decl. ¶ 18. Brown initially purchased annuities from Smart. See Fitzsimons Decl. ¶ 18. Smart later advised Brown to liquidate her annuities and invest the proceeds in Smart Assets, which, in turn, would invest in various funds, including an “S&P” mutual fund. See Fitzsimons Decl. ¶ 9. Brown was promised that her funds would be invested in stable, liquid securities and that her principal was guaranteed. See Fitzsimons Decl. ¶ 9.

Padilla invested approximately \$1.1 million with Smart. See Fitzsimons Decl. ¶ 24. Smart told Padilla that the majority of her money would be invested in “[l]ow risk or fixed funds offering [p]rincipal guaranteed protection with above average returns.” See Exhibit 3 to Fitzsimons Decl. Smart stated that the fixed rate funds offered 5.5% annual returns. See Fitzsimons Decl. ¶ 11. Smart also told Padilla that \$425,000 of her investment was invested in a “ROI (return on investment) company called Golden Key [I]nvestments.” See Exhibit 3 to Fitzsimons Decl. Smart stated that the investment would “generate a monthly income of \$3,000.” See Exhibit 3 to Fitzsimons Decl.. He described her investments as “[n]ot to [*sic*] flashy, but very solid and safe.” See Exhibit 3 to Fitzsimons Decl. Moreover, in September 2008, Smart’s attorney, J. Kent Holland,

wrote a letter on behalf of Smart reassuring Padilla that her “funds are placed along with others, in a pool for investments.” See Exhibit 17 to Fitzsimons Decl.

Both Padilla and Brown received “dividend” payments from Smart’s investments. The monthly payments were often late. See Fitzsimons Decl. ¶ 14. In Padilla’s case, the dividend payments stopped in February 2008. See Fitzsimons Decl. ¶14. From February 2006 through August 2008, Brown redeemed approximately \$17,000 from Smart Assets. See Fitzsimons Decl. ¶ 21. However, after 2008, Smart no longer provided Brown with access to her money, despite her repeated requests that he do so. See Fitzsimons Decl. ¶ 22.

Smart sporadically provided account statements to Brown, and repeatedly refused to provide Brown and Padilla with an accounting of their investments, despite their repeated requests. See Fitzsimons Decl. ¶ 10. The account statements that Smart did provide to Brown created the appearance that Smart was a financial advisor and that he was investing her funds in mutual funds and similar securities. See Fitzsimons Decl. ¶ 15. However, it now appears that the account statements contained false information relating to both the asset balances and allocations.

Phase II

Beginning in November 2005, Dagmar Chaplin-Lee (“Lee”) began investing with Smart. See Fitzsimons Decl. ¶ 25. Smart represented to Lee that he was a financial advisor and provided assurances that her money would be invested in low risk and liquid funds. See Fitzsimons Decl. ¶ 25. Lee was told that she would have access to her money at all times. See Fitzsimons Decl. ¶ 25.

On November 23, 2005, Smart and Smart Assets offered and sold a \$200,000 promissory note to Lee, promising a rate of 8.5% per year. As collateral for the note, Smart and Smart Assets offered an \$870,000 promissory note executed by Kate Edwards (“Edwards”). See Fitzsimons Decl. ¶ 26. Smart also issued a “Membership Certificate” to Lee for 200,000 units of Smart Assets. See Fitzsimons Decl. ¶ 27. Smart provided

Lee with account statements that reflect her monies invested in order to give the appearance that her money was invested in stable securities. See Fitzsimons Decl. ¶ 28.

In February 2006, Lee invested another \$50,000 with Smart through a promissory note offering an 18% annual rate. See Exhibit 14 to Fitzsimons Decl. In November 2005, Smart told Lee that he was affiliated with AIM Association – an insurance brokerage located in California. See Fitzsimons Decl. ¶ 31. He also told Lee in February 2008, that she and Brown’s assets were invested in a Hawaiian real estate deal. See Fitzsimons Decl. ¶ 32. One month later, Smart told Lee that they were invested in a company called Pharm Meds. See Fitzsimons Decl. ¶ 33.

From February 2006 through August 2008, Lee redeemed approximately \$47,500. See Fitzsimons Decl. ¶ 35. Smart now refuses to redeem the rest of her investment. See Fitzsimons Decl. ¶ 36. Since 2007, Lee has repeatedly requested that Smart provide account information on her investments and has not received any such information. See Fitzsimons Decl. ¶ 37.

Phase III

In July 2006, Smart solicited Ryan and Joanna Smith (the “Smiths”) to invest in “hard money” real estate lending. See Fitzsimons Decl. ¶ 38. In August 2006, Smart offered and sold a \$100,000 promissory note to the Smiths, offering a 10% per month rate of return. See Exhibit 16 to Fitzsimons Decl. While Smart made some of the monthly payments on the notes, the payments stopped January 2008. See Fitzsimons Decl. ¶ 39. Eighteen months after their initial real estate investments, Smart informed the Smiths that, rather than investing their money in real estate as he had promised, their money was invested in a company that manufactures “slurry ice.” See Fitzsimons Decl. ¶ 38.

Defendants Misuse of Investor Funds

Rather than invest investor funds in mutual funds or other safe, liquid investments, it appears that Smart likely used investor funds to invest in highly risky real estate ventures, for his own personal use, and to pay previous investors.

Prior to 2006, Smart was heavily invested in real estate in Southern California. See Fitzsimons Decl. ¶ 12. In or around 2005, Smart invested in an \$870,000 promissory note to Kate Edwards (“Edwards”). See Fitzsimons Decl. ¶ 12. The promissory note was backed by commercial real estate. At some point, Edwards failed to repay the note and Smart took possession of the Edwards’ building. See Fitzsimons Decl. ¶ 12. Smart told a business associate that he was leveraging the Edwards property for a large, risky land investment in Draper, Utah. See Fitzsimons Decl. ¶ 12. According to the same business associate, Smart also borrowed money on real estate after it had been foreclosed upon. See Fitzsimons Decl. ¶ 12. It now appears that Smart used Brown’s and Padilla’s investments to invest in the failed Edwards deal.

Smart also teamed up with the firm Golden Key (“Golden Key”) to invest in a slurry ice manufacturer called Vision Natural. Golden Key eventually failed after one of the principals of Vision Natural purportedly absconded with investor funds. See Fitzsimons Decl. ¶ 12. Smart never told investors that their investments in Vision Natural was lost.²

² Smart met some of his investors while working at an insurance brokerage firm called AIM Association. See Fitzsimons Decl. ¶ 16. However, Smart was terminated from AIM Association in 2004, and had no affiliation with AIM Association after that date. See Fitzsimons Decl. ¶ 16. Despite this fact, Smart continued to tell investors that he was working for AIM Association, long after he was terminated. He also used an AIM Association e-mail address to further convince investors that he was associated with AIM Association. See Fitzsimons Decl. ¶ 17. Finally, Smart used the alias d/b/a of Smart/AIM and told one investor that he was opening AIM Association’s Utah office. See Fitzsimons Decl. ¶ 25.

ARGUMENT

III. DEFENDANTS VIOLATED THE ANTIFRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS

a. A Temporary Restraining Order is Necessary to Protect Investors and the Public Interest

Section 20(b) of the Securities Act [15 U.S.C. § 77(b)] and Section 21(d) of the Exchange Act [15 U.S.C. § 78u(d)] empower the Court to grant injunctive relief where it appears that a person is engaged in or about to engage in violations of the federal securities laws. Under these sections, the Commission is required to make a "proper showing" of violative activity in order to obtain injunctive relief.

When a federal agency charged by statute with safeguarding the public interest brings an action for injunctive relief, irreparable injury may be presumed. See, e.g., United States v. Odessa Union Warehouse Co-Op, 833 F.2d 172, 174-75 (9th Cir. 1987). In order to obtain preliminary relief or a permanent injunction the Commission needs to prove: (1) a prima facie case of previous violations; and (2) a reasonable likelihood that the wrong will be repeated. See e.g., SEC v. Unifund Sal, 910 F.2d 1028, 1036-37 (2d Cir. 1990); SEC v. Mgmt. Dynamics, Inc., 515 F.2d 801, 807 (2d Cir. 1975); SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082, 1100 (2d Cir. 1972). The Commission faces a lower burden than a private litigant when seeking a temporary restraining order or preliminary injunction. Hecht Co. v. Bowles, 321 U.S. 321, 331 (1944); Mgmt. Dynamics, Inc., 515 F.2d at 808; SEC v. Int'l Loan Network, Inc., 770 F. Supp. 678, 688 (D.D.C. 1991), aff'd, 968 F.2d 1304 (D.C. Cir. 1992). For example, unlike private litigants, the Commission is not required to show irreparable injury or a balance of equities in its favor in order to make the statutory "proper

showing" to obtain a preliminary injunction. Unifund Sal, 910 F.2d at 1036; SEC v. Torr, 87 F.2d 446, 450 (2d Cir. 1937); SEC v. Musella, 578 F. Supp. 425, 434 (S.D.N.Y. 1984).

b. The Commission Has Established Its Prima Facie Case

i. Defendants Made False Statements and Material Omissions in Connection with the Purchase or Sale of Securities

Section 17(a) of the Securities Act [15 U.S.C. §77q(a)] prohibits persons, in the offer or sale of a security, from employing any device, scheme or artifice to defraud; obtaining money or property through materially false or misleading statements or omitting to state material facts; or engaging in any transaction, practice, or course of business which operates as a fraud or deceit. United States v. Naftalin, 441 U.S. 768, 773 (1979). Section 10(b) of the Exchange Act and Rule 10b-5 thereunder prohibit similar conduct in connection with the purchase or sale of a security. Section 10(b) was designed to prevent all manner of fraudulent practices. Chiarella v. U.S., 445 U.S. 222, 226 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976); Affiliated Ute Citizens of Utah v. U.S., 406 U.S. 128, 153 (1972); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

Defendants made numerous misrepresentations and omissions to investors. Defendants claimed that investor funds were invested in low risk, principal guaranteed mutual funds. Instead of placing investor funds in secure investments, Defendants transferred almost all investor funds to risky real estate deals. Defendants did not disclose the substantial losses sustained in the real estate transactions, including the defaulted Edwards note or the total loss of the Vision Natural investment. Defendants also failed to tell investors that the monthly "dividend" payments they received came

from subsequent investors rather than from investment profits. Finally, Defendants neglected to mention that they used investor funds for personal purposes.

Specifically, Smart did not tell Brown, Lee, and Padilla that their assets were not in safe, principal guaranteed mutual funds, as he suggested, but were instead invested in a risky real estate deal with Edwards. When Edwards defaulted on the \$870,000 note, Smart also failed to tell Brown and Padilla that the bulk of their investments were lost. Similarly, Smart misled the Smiths into believing that they were investing in real estate ventures. It was not until 18 months later that he finally told them that they were invested in Vision Natural and he failed to inform them that their money was misappropriated by Vision Natural's principal. Finally, Smart did not tell any of his investors that he was using their funds for his own personal use or to pay previous investors' dividends.

ii. Defendants' Misrepresentations and Omissions Were Material

Information is material if a substantial likelihood exists that the facts would have assumed actual significance in the investment deliberations of a reasonable investor. Basic, Inc. v. Levinson, 485 U.S. 224 (1988). Defendants' misrepresentations regarding the use of investors' funds are material. See SEC v. Cochran, 214 F.3d 1261, 1268 (10th Cir. 2000) (information implicating the fair market value would be material to a reasonable investor); Everest Sec., Inc. v. SEC, 116 F.3d 1235, 1239 (8th Cir. 1997) (It would be material to an investor to know that the offering company's existing project had been abandoned, that none of its asset value was to be recouped.) Similarly, investors would consider it important to know their funds were being misappropriated by Defendants and that Smart and Smart Assets operated as a Ponzi-like scheme. SEC v. TLC Invs. & Trade Co., 179 F. Supp. 2d 1149, 1153 (C.D. Cal. 2001); see also SEC v.

Smith, 2005 U.S. Dist. LEXIS 21427, at *15 (S.D. Ohio Sept. 27, 2005) (it is obvious that a reasonable investor would consider it important to know that his money would not be invested in bank stock but would instead be used for other purposes, such as to pay for American Express bill, car washes, dating services, and the expenses of other companies).

iii. Defendants Acted With Scienter

Scienter is an element of violations of Section 17(a)(1) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, but is not a required element of a violation of Sections 17(a)(2) or 17(a)(3) of the Securities Act. Aaron v. SEC, 446 U.S. 680, 696-97 (1980). The Supreme Court has defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud." Ernst & Ernst, 425 U.S. at 193. Reckless conduct has been held to satisfy the scienter requirement. Edward J. Mawod & Co. v. SEC, 591 F.2d 588, 595-597 (10th Cir. 1979).

Here, Defendants acted with the requisite scienter. Smart was the only person involved with soliciting his investors. He met, either in person or by phone, with each investor, and carefully explained to them how their investments would be allocated to low risk funds with principal guaranteed protection. He described these investments as "not to[o] risky, but very solid and safe." However, Smart knew or should have known that he was investing the assets in risky, real estate lending deals, rather than principal guaranteed mutual funds. Indeed, he did not disclose that Lee's promissory note was secured with an \$870,000 promissory note that may have already been in default. Moreover, Smart knew or should have known that rather than invest the Smiths' money

in real estate investments, he misallocated the funds to a risky commercial lending scheme.

iv. Defendants' Fraud Occurred In Connection With the Purchase or Sale of Securities

As the Supreme Court recently reaffirmed, the “in connection with” requirement is to be construed broadly and flexibly to effectuate its remedial purposes. SEC v. Zandford, 535 U.S. 813, 819 (2002) (“It has maintained that a broker who accepts payment for securities . . . or who sells customer securities with intent to misappropriate the proceeds, violates §10(b) and Rule 10b-5”). Thus, the “in connection with” requirement is satisfied when someone utilizes a device “that would cause reasonable investors to rely thereon” and “so relying, cause them to purchase or sell a corporation’s securities.” In re Carter-Wallace, Inc. Sec. Litig., 150 F.3d 153, 156 (2d Cir. 1998) (citing SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 860-62 (2d Cir. 1968) (Section 10(b) applies “whenever assertions are made . . . in a manner reasonably calculated to influence the investing public.”); SEC v. Savoy Indus., Inc., 587 F.2d 1149, 1171 (D.C. Cir. 1978) (“In connection with” requirement is satisfied when it can reasonably be expected that a publicly disseminated document will cause reasonable investors to buy or sell securities “regardless of the motive or existence of contemporaneous transactions by or on behalf of the violator.”); see also In re Ames Dep’t Stores, Inc. Stock Litig., 991 F.2d 953, 966 (2d Cir. 1993) (“[S]tatements which manipulate the market are connected to resultant stock trading.”); SEC v. Rana Research, Inc., 8 F.3d 1358, 1362 (9th Cir. 1993). Moreover, the “in connection with” requirement is met regardless of whether or not Defendants invested the money in securities. See Zandford, 535 U.S. at 819. All that is required is that an investor would reasonably believe that they are investing in securities. Id.

Defendants conduct in this case coincided with the sale of securities. Defendants sold promissory notes, mutual funds and other securities. Smart's misrepresentations regarding the use of funds occurred in the course of selling the securities to investors. Indeed, the investors would likely not invest in Smart or Smart Assets without Smart's misrepresentations regarding the use and risky nature of their investments. It does not matter that Defendants never invested the investor's money in mutual funds despite his statements that he would do so. See Zandford, 535 U.S. at 819. Nor does it matter if Smart actually invested in Golden Key. Id. All that matters is that investors reasonably believed that the Defendants invested their money in securities, such as mutual funds and Golden Key. Id.

v. Defendants Used the Means and Instrumentalities of Interstate Commerce

Defendants used the requisite jurisdictional means to affect the fraud. In Pereira v. U.S., 347 U.S. 1, 8-9 (1954), the United States Supreme Court noted that it is sufficient if a defendant knows that the use of mail or of wire services was a reasonably foreseeable consequence of a scheme to satisfy the "jurisdictional means" element. "All that is required to establish a violation of [Section 17(a), Section 10(b) or Rule 10b-5] is a showing that a means, instrumentality or facility of a kind described in the introductory language of th[e] section was used, and that in connection with that use an act of a kind described . . . occurred." Matheson v. Armbrust, 284 F.2d 670, 673 (9th Cir. 1960), cert. denied, 365 U.S. 870 (1961); accord, United States v. Tallant, 547 F.2d 1291, 1297 (5th Cir. 1977), cert. denied, 434 U.S. 889 (1977). Here, Defendants made use of the mails, of the Internet, and of the telephone to solicit investments. Funds were wired to the Defendants' bank accounts. That is all that is required.

II. THE INVESTMENTS SOLD BY DEFENDANTS ARE SECURITIES

The promissory notes and joint venture agreements that Defendants offered and sold are securities as either notes or investment contracts. In assessing whether an investment is a security, the United States Supreme Court has noted that the fundamental purpose of the Securities Acts is “to eliminate serious abuses in a largely unregulated securities market.” United House Found., Inc. v. Forman, 421 U.S. 837, 849 (1975). In defining the scope of the products Congress wished to regulate, Congress painted with a broad brush. It realized the virtually unlimited scope of “human ingenuity, especially in the creation of ‘countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.’” Reves v. Ernst & Young, 494 U.S. 56, 60-61 (1990) (quoting SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946)).

a. The Notes Sold By Defendants are Investment Contracts

Investment contracts are securities within the scope of the Securities Acts. An investment contract is a security if it involves (1) investment of money; (2) in a common enterprise; (3) with profits derived from others’ efforts. SEC v. W.J. Howey Co., 328 U.S. 293, 301 (1946). This definition has been applied to a variety of situations, including pyramid schemes. See, e.g., Int’l Loan Network, Inc., 770 F. Supp. at 692. Some jurisdictions interpret the phrase “common enterprise” differently and require additional analysis such as horizontal or vertical commonality. However, the Tenth Circuit has specifically rejected a rigid horizontal commonality test. See McGill v. American Land & Exploration Co., 776 F.2d 923, 925-926 (10th Cir. 1985). Instead, the court looks to the “economic reality” of the transaction. Id. Thus, if a “transaction is in

reality an investment (that is, a transaction of a type in which stock is often given), then it creates a ‘common enterprise’ or a ‘security.’” Id. (citations omitted).

Here, the note-holders unquestionably invested money with the Defendants. The funds were pooled in a common enterprise. Indeed, Smart’s attorney sent a letter on behalf of Smart to one of his investors assuring her that her “funds are placed along with others, in a pool for investments.” And Lee was issued “membership certificates” for 200,000 units of Smart Assets in return for her investment in the Defendants’ notes.

Indeed, the Defendants’ promissory notes are not merely loan agreements. These notes were “not loans for commercial purposes, but were investment payouts disguised beneath the façade of promissory notes. It is hard to imagine a more perfect example of the Howey investment contract.” SEC v. Better Life Club of Am., Inc., 995 F. Supp. 167, 174 (D.D.C. 1998). Moreover, the fact that Defendants offered a fixed rather than variable rate of return does not affect the investments’ status as a security. See SEC v. Edwards, 540 U.S. 389, 397 (2004) (analyzing Howey and holding “an investment scheme promising a fixed rate of return can be an ‘investment contract’ and thus a ‘security’ subject to the federal securities laws”); Stoiber v. SEC, 161 F.3d 745, 750 (D.C. Cir. 1998) (holding fixed rate notes are securities); Pollack, 27 F.3d at 813 (noting fixed rate bonds are regulated as securities). Likewise, the short term of the notes also has no impact on whether the notes fall within the definition of a security. See Wallenbrock, 313 F.3d at 540 (explaining the exception for notes with maturity of less than nine months “applies only to commercial paper, defined by the Supreme Court as ‘short-term, high quality instruments issued to fund current operations and sold only to highly sophisticated investors’”); Better Life Club, 995 F. Supp. at 174 (holding sixty and

ninety day notes were securities). These investments are securities and subject to the antifraud provisions of the federal securities laws.

b. The Notes Defendants Sold are Securities Under Reves

According to the United States Supreme Court, notes are presumed to be securities unless the notes fall into certain judicially created categories that are plainly not securities or the notes bear a family resemblance to the notes in those categories. Reves, 494 U.S. 56 (1990). The Reves Court identified four facts to be considered in determining whether a particular note is a security. These four elements are:

(1) the motivations that would prompt a reasonable seller and buyer to enter into [the transaction]. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security" (2) the "plan of distribution" of the instrument (3) the reasonable expectations of the investing public [and] (4) whether some factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.

Id. at 951-52. None of the four factors is crucial and the failure of one will not automatically result in a Court's concluding that the note in question is not a security. Rather, Courts take a balancing approach to determine whether, on the whole, the note looks more like a security than not. In re NBW Commercial Paper Litig., 813 F. Supp. 7, 10 at n.7 (D.D.C. 1992) (holding commercial paper was a security).

i. The Motivations of the Parties

The first factor under Reves is an objective inquiry into the "motivations that would prompt a reasonable seller and buyer to enter into' the transaction." SEC v. J.T. Wallenbrock & Assocs., 313 F.3d 532, 537 (9th Cir. 2002). A note is more like a security "if the seller's purpose is to raise money for the general use of a business

enterprise . . . and the buyer is interested primarily in the profit the note is expected to generate.” Reves, 494 U.S. at 66; see also Pollack v. Laidlaw Holdings, Inc., 27 F.3d 808, 812 (2d Cir. 1994) (“The inquiry is whether the motivations are investment (suggesting a security) or commercial or consumer (suggesting a non-security).”)

Alternatively, a promissory note that “is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller’s cash-flow difficulties, or to advance some other commercial or consumer purpose” will “less sensibly [be] described as a ‘security.’” Reves, 494 U.S. at 66.

The first factor puts the promissory notes comfortably in the category of a security. Here, the investors were not provided any information regarding any assets that purportedly backed up the promissory notes – other than the fact that the investments would be used for “real estate.” See Wallenbrock, 313 F.3d at 538 (lack of information regarding assets backing loan indicated investment for general business purposes). In fact, the Notes indicated on their face that they were to be used for a “business purpose only.” Moreover, the attractive interest rate offered to investors suggests the Notes are securities. See Wallenbrock, 313 F.3d at 538 (a promised interest rate above market rates suggested a security). Here, the Notes offered an interest rate of up to 10% per month. Again, suggesting the Notes are securities.

ii. The “Plan of Distribution” for the Instrument

The second factor requires the examination of the plan of distribution of a note “to determine whether it is an instrument in which there is ‘common trading for speculation or investment.’” Reves, 494 U.S. at 66. The terms of the promissory note made to the Smiths and Lee do not preclude trading in a secondary market, but it is highly unlikely

that any notes have been resold or that any investors have contemplated reselling them. Furthermore, the persons to whom the notes were sold appear to be limited to Smart's clients. This one factor, however, does not rebut the presumption that the notes are securities. In a case similar to the facts uncovered in this investigation, a person associated with a broker-dealer, Gerald Stoiber, approached thirteen customers and borrowed various sums of money to purportedly finance commodities trading in his own account. Stoiber executed unsecured promissory notes with terms of two to five years and fixed interest rates ranging from six to twelve percent. The court found that the notes were securities. See Stoiber v. SEC, 161 F.3d 745 (D.C. Cir. 1998).

iii. The Reasonable Expectations of the Investing Public

Under the third Reves factor, this Court must consider "whether a reasonable member of the investing public would consider these notes as investments." McNabb v. SEC, 298 F.3d 1126, 1132 (9th Cir. 2002). The opinions of individual investors as to whether the notes are securities are irrelevant. Id. Such admissions add little, if anything, to the analysis. Id. (citing Stoiber v. SEC, 161 F.3d 745, 751 (D.C. Cir. 1998)). A reasonable investor would view the Promissory Notes as an investment. The Notes specifically state that the funds will be used for business purposes and Smart told the investors that the funds would be used for further investments. The investors understood that the monthly dividend payments would be made from the proceeds of that further investment. A reasonable investor would view such a transaction as a security purchase.

iv. Reduction of Risk

The final factor for the Court to assess is whether there are adequate risk-reducing factors such as an alternative regulatory scheme that would "significantly reduce[] the

risk of the instrument” to the lender, “thereby rendering application of the Securities Acts unnecessary.” Reves, 494 U.S. at 67. Here, there are no risk-reducing factors or alternative regulatory schemes that would reduce the risk to the investors in this case. There is no other alternative regulatory scheme to reduce this risk to investors. In addition, it does not appear that there is any real, valuable collateral securing the notes, only a note that appears to already have been in default. Nor were the notes in any way insured. Other than the federal securities laws, there are no other regulatory schemes that provide oversight of the issuance of the notes or Smart’s handling of the notes. Accordingly, the facts under the fourth prong of the Reves suggest that the promissory notes are securities.

III. THERE IS A REASONABLE LIKELIHOOD THAT THE DEFENDANTS WILL PERSIST IN THEIR ILLEGAL CONDUCT UNLESS ENJOINED

The Commission must establish the likelihood of future violations to obtain an injunction. SEC v. Murphy, 626 F.2d 633 (9th Cir 1980). The Commission must “go beyond the mere facts of past violations and demonstrate a realistic likelihood of recurrence.” SEC v. Commonwealth Chem. Sec., Inc., 574 F.2d 90, 100 (2d Cir. 1978). In ascertaining the likelihood of future violations, the Court should look at several factors, including the degree of scienter; the egregiousness of the violation; whether the defendant will have opportunities for future violations; and, whether the defendant has acknowledged wrongdoing and made sincere assurances against future violations. SEC v. Pros Int’l, Inc., 994 F.2d 767, 769 (10th Cir.1993) (citing SEC v. Youmans, 729 F.2d 413, 415 (6th Cir. 1984)); SEC v. Blatt, 583 F.2d 1325, 1334 at n.29 (5th Cir. 1978). Furthermore, in ascertaining the likelihood of future violations, the Court should look at “the totality of circumstances and factors suggesting that the infraction might not have

been an isolated occurrence.” SEC v. Am. Realty Trust, 429 F. Supp. 1148, 1175 (D. Va. 1977) (reversed on other grounds by SEC v. Am. Realty Trust, 586 F.2d 1001 (4th Cir. 1978)); see also, SEC v. Fehn, 97 F.3d 1276, 1295-96 (9th Cir. 1996); Pros Int’l, 994 F.2d at 769 (citing SEC v. Youmans, 729 F.2d 413, 415 (6th Cir. 1984)). This was not an isolated instance. Defendants constructed an elaborate scheme to defraud investors over a period of years. The conduct is ongoing, and Defendants are willing and able to continue their fraudulent behavior.

The Court should also consider “the likelihood that the defendant’s customary business activities might again involve him in such transactions.” SEC v. Suter, 732 F.2d 1294, 1301 (7th Cir. 1984); see also SEC v. Holschuh, 694 F.2d 130, 144 (7th Cir. 1982); SEC v. Zale Corp., 650 F.2d 718, 720 (5th Cir. 1981); Murphy, 626 F.2d at 655; Commonwealth Chem., 574 F.2d at 100. Although no single factor is determinative, the Tenth Circuit held that the degree of scienter “bears heavily” on the decision. Pros Int’l, 994 F.2d at 769 (citing SEC v. Haswell, 654 F.2d 698, 699 (10th Cir. 1981)). Smart has no other foreseeable income other than that derived from his “financial advising” business and therefore is likely to be involved in investment schemes in the future. As explained above, Defendants knew, or should have known, that their conduct defrauded numerous investors. All of these factors, including a high degree of scienter, are present in the instant case.

IV. AN ASSET FREEZE IS NECESSARY TO PREVENT FURTHER DIVERSION AND DISSIPATION OF INVESTOR FUNDS AND TO PRESERVE THE STATUS QUO

To obtain an asset freeze, the Commission must show a prima facie case that a violation of the securities laws has occurred. See Unifund Sal, 910 F.2d at 1040-41; see also

15 U.S.C. §§ 77t(b) and 78u(d)(1). A freeze order may be obtained even without showing a likelihood of future violations. See Unifund Sal, 910 F.2d at 1041 (citing Commonwealth Chem., 574 F.2d at 103 at n.13). The Commission's burden when seeking an asset freeze is lower than its burden when seeking a temporary restraining order or preliminary injunction against statutory violations, because such injunctive relief raises the specter of future liability for contempt, while an asset freeze only preserves the status quo. See Unifund Sal, 910 F.2d at 1039. Unlike private litigants, the Commission need not show risk of irreparable injury or the unavailability of remedies at law in a request for preliminary relief. See id. at 1036.

The rationale for this rule is readily apparent. It requires little elaboration to make the point that the SEC appears in these proceedings not as an ordinary litigant, but as a statutory guardian charged with safeguarding the public interest in enforcing the securities laws. Hence, by making the showing required by statute that the defendant "is engaged or about to engage" in illegal acts, the Commission is seeking to protect the public interest, and "the standards of the public interest, not the requirements of private litigation, measure the propriety and need for injunctive relief."

Management Dynamics, 515 F.2d at 808-809 (quoting Hecht Co., 321 U.S. at 331).

As set forth above, the Commission has established a prima facie case that a violation of the federal securities laws has occurred. The evidence accompanying this memorandum demonstrates that Defendants defrauded numerous investors of at least \$1.68 in a blatant Ponzi scheme. Defendants used investor funds for personal expenses and diverted funds to high-risk investments rather than the conservative, "principal protected" mutual funds and real-estate-backed investments as he represented to investors. Under those circumstances, an asset freeze is appropriate to conserve whatever remains of investors' funds.

It is also necessary to obtain the asset freeze against Defendants on an ex parte basis. In past cases involving fraud, when the Commission has provided defendants with notice of an application for a temporary restraining order containing an asset freeze, defendants have taken the opportunity to hide or dissipate investor funds. See e.g., Current Fin. Servs., 100 F. Supp. 2d 1 (D.D.C. 2000) (\$150,000 transferred to defense counsel); SEC v. Interlink Data Network of Los Angeles, Inc., Civil No. 93 3073 R, 1993 U.S. Dist. LEXIS 20163 (C.D. Cal. Nov. 15, 1993) (\$25,000 transferred to defense counsel between notice of proposed application and entry of freeze order). This Court should not allow these Defendants the opportunity to transfer investor funds to hide them or pay for legal expenses.

V. THIS COURT SHOULD APPOINT A RECEIVER OVER THE DEFENDANTS' ASSETS

The Court's authority to appoint a receiver is well established and has been exercised in similar cases in the past. SEC v. R.J. Allen & Assocs., Inc., 386 F. Supp. 866, 878 (S.D. Fla. 1974). Courts have wide discretion to order equitable relief in SEC actions. In re San Vicente Med. Partners Ltd., 962 F.2d 1402, 1406 (9th Cir. 1992). "The Court may appoint a receiver on a prima facie showing of fraud and mismanagement." SEC v. Current Fin. Servs., Inc., 783 F. Supp. 1441, 1443 (D.D.C. 1992). As set forth above, the Commission has already made a strong prima facie showing of fraud and mismanagement. Thus, a receiver is warranted.

VI. AN ORDER EXPEDITING DISCOVERY IS APPROPRIATE

The Commission seeks to depose witnesses, subpoena documents and take other discovery. Due to the threat of funds being removed and the fraud continuing, the Commission has brought this action expeditiously. Prompt resolution of this matter is critical to prevent further violative conduct. Expedited discovery of matters concerning

Defendants' activities in connection with the sale of securities will permit the Commission to effectuate any Order entered by this Court freezing assets and promptly ascertain the appropriate disposition of such funds. Accordingly, the Commission has requested that expedited discovery be permitted in the manner described in the Order.

VII. THIS COURT SHOULD ISSUE AN ORDER REQUIRING DEFENDANTS TO SUBMIT AN ACCOUNTING OF INVESTOR FUNDS AND OTHER ASSETS

The Commission requests that this Court enter an order requiring each defendant to submit a verified accounting for the purpose of identifying: (i) the location and amount of all funds received from investors; and (ii) the location and value of all personal or company assets presently held by them, under their control, or over which they exercise actual or apparent investment authority. This accounting will assist the Court to determine the scope of the fraudulent scheme and the appropriate scope of the asset freeze order. In addition, an order for an accounting will make it more difficult for defendants and their agents to secrete assets during the pendency of the litigation in anticipation of a final order requiring disgorgement and civil penalties. See, e.g., SEC v. International Swiss Invs. Corp., 895 F.2d 1272, 1274 (9th Cir. 1990).

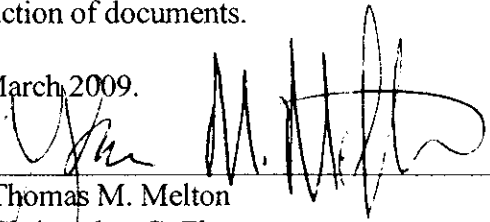
VIII. THIS COURT SHOULD ISSUE AN ORDER PREVENTING THE ALTERATION OR DESTRUCTION OF DOCUMENTS

The defendants have already shown the lengths to which they will go to avoid compliance with the federal securities laws. To protect the documents necessary for full discovery in this matter, the Commission seeks an order preventing the alteration or destruction of documents; good faith preservation of documents cannot be assumed. Such an Order is appropriate to protect the integrity of this litigation.

CONCLUSION

Based on the forgoing, the Commission respectfully requests this Court grant the Motion for Temporary Restraining Order, enter an Order freezing defendants' assets, expediting discovery, and preventing the destruction of documents.

Respectfully submitted this 11 day of March 2009.



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