FINRA's Hunt for Insider Trading Cases in Illiquid Markets

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Byline: Stanley S. Arkin and Lisa C. **Solbakken**

Body

O ver the last several years, the Financial Industry Regulatory Authority (FINRA) has continued to emerge as a consequential securities transaction regulator, acting in the stead of the traditional authority imposed by the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC). Certainly, this manner of delegation of a prosecutorial function to an administrative agency has been the subject of criticism. See, e.g., Nov. 5, 2014, PLI Securities Regulation Institute Keynote Address, "Is the SEC Becoming a Law Unto Itself?" Hon. Jed S. Rakoff, U.S.D.J. Nonetheless, for various reasons beyond the scope of this article, it is a trend that is very likely to continue, with limited imposition of oversight.

Consequently, FINRA can and does pursue insider trading prosecutions that, for whatever reason, were not pursued by the SEC, the DOJ or an Article III court. Leaving aside why this is the case, including, for example, instances where said actions were deemed simply unworthy of investigation, the result is that FINRA is left to act at the margins. The article herein considers one such marginal action within the context of a case recently tried before FINRA regulators; namely, Dep't of **Market** Regulation v. Jack Lawrence Howard, Disciplinary Proceeding No. 20110263957-01 (RSH), June 29, 2015 Hearing Panel Decision (http://bit.ly/1M1py3S).

The Howard case is notable on a number of levels. First, it is a rare example of alleged insider trading in a publicly traded but non-reporting shell company about which very little public information is available. Although the Panel's decision did not purport to establish a bright-line rule that the relatively small volume of information available about a non-reporting shell requires a departure from the traditional definition of materiality, the case highlights interesting issues that arise when applying insider trading principles in such circumstances.

Second, more broadly, Howard showcases one of the many insider-trading cases involving the OTC or "Pink Sheet" **markets** that are prosecuted by FINRA. Indeed, FINRA appears to have a unique opportunity to define the contour and scope of prohibited trading in these **markets** that are largely unfettered by existing precedent from the SEC or the federal courts. As the Howard panel noted, there is simply a dearth of case law that might resolve nuances particular to **illiquid markets**. The unsettled state of the law in these **markets** leaves to an increasingly vigorous disciplinary office at FINRA an opportunity to cast broad nets inconsistent with traditional insider trading analyses.

BACKGROUND

In late 2010, Howard was the Chairman, CEO and largest shareholder of Gateway Industries (Gateway), a nonoperating (and non-reporting) shell company whose shares traded over-the-counter (OTC). Id. at 3. At that time, Gateway had no assets, and its shares traded between $.01 and $.02 per share. Id. The Panel noted that despite being a public company, Gateway had no operations or publicly available financial statements, and made no filings with the SEC. Its stock traded infrequently on the Pink Sheets. (Pink Sheets LLC is now part of OTC **Markets** Group.) The only publicly available information about Gateway in 2010 was outdated historical financial statements from older SEC filings. Id. at 3.

FINRA's Department of **Market** Regulation alleged that Howard engaged in insider trading by purchasing shares of Gateway while in possession of material non-public information concerning a potential merger transaction. The charges against Howard included alleged violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, and FINRA Rules 2010 and 2020. It was not disputed that Howard (through a trader) made three trades on Oct. 28, Nov. 10, and Nov. 11, 2010 - purchasing a total of 200,000 Gateway shares - while in possession of the following non-public information:

1. On Oct. 27, Howard received a phone call from an investment banker, on behalf of an unnamed client, inquiring about the availability of CoSine Communications, a shell with which Howard was affiliated;

2. The investment banker stated that the client was looking for a publicly traded shell company with $20 million in cash for a potential reverse merger;

3. During that call, Howard advised that CoSine was not available;

4. The following day, Howard informed the banker that he had another shell company (Gateway) that was available, but that it had no cash or assets;

5. The investment banker had told Howard that the client was "sophisticated," "successful," and had done reverse mergers in the past;

6. On Nov. 5, the banker e-mailed Howard an unexecuted draft Non-Disclosure Agreement (NDA), which for the first time identified her client; and

7. Howard did not sign and return the NDA until Nov. 11.

Id. at 5-14.

Thereafter, negotiations with Sillerman ultimately resulted in a reverse merger transaction, which Gateway announced in February 2011. Gateway's share price increased from $.01 to $1.89. Six months later, Howard sold his entire stake in Gateway for a total of $1.2 million. Id. at 13-14.

THE PANELS ANALYSIS

The Panel held that, despite the fact that Howard knew the above non-public information at the time of the subject trades, DMR had "failed to establish that the information Howard possessed was material." Id. at 14. Therefore, DMR's complaint had to be dismissed.

The Panel reasoned that Howard's discussions with Sillerman's banker were too preliminary, and the possibility of a transaction too remote, for the information to be "material." The Panel noted at the outset the standard of materiality generally applicable to securities fraud and insider trading cases: "Information is material only if it 'significantly alter[s] the 'total mix' of information made available,' such that there is a 'substantial likelihood that a reasonable investor would consider it important in deciding whether to buy or sell shares.'" Id. at 15 (quoting TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)). The Panel explained that the materiality of information about a contingent or speculative future event - such as a merger or recapitalization - "depend[s] at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." Id. (quoting Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988)).

Applying those principles, the Panel concluded that the non-public information known to Howard "was clearly preliminary, contingent and speculative,' and the probability that any transaction between Gateway and Sillerman would occur was low." Id. at 16 (quoting Taylor v. First Union Corp., 857 F.2d 240, 244-45 (4th Cir. 1988)). Therefore, the Panel held, the information was immaterial as a matter of law.

By employing this analysis, the Panel also rejected DMR's call for a lower materiality threshold for non-reporting companies. Key to Howard's success on this issue was the Panel's rejection of DMR's contention that materiality turns on the precise volume or amount of information available about the company. That is, DMR contended that while a fact might be immaterial to a public company about which substantial public information is available (such as a company that files regular reports with the SEC), something far more benign might be material to a non-reporting company. DMR reasoned that a fact is more likely to alter the "total mix" of information available if the "total mix" of information is very small. Thus, DMR argued, "When there is little public information about a company, it is axiomatic that any new information will likely have a greater impact upon the total mix of information available."

Without question, the Panel was interested in exploring the distinction DMR drew between a non-reporting company, about which there was little public information, and a reporting company, about which there is extensive public information.

In fact, in a pre-hearing order, the Panel framed the question raised by DMR's argument as follows: "Since Gateway was not a reporting company, and there was little public information available about Gateway, did information about the potential transaction between Gateway and Sillerman significantly alter the total mix of information available about Gateway?"

DMR'S ARGUMENT

DMR argued in the affirmative, citing two cases. The first was SEC v. Bauer, 723 F.3d 758 (7th Cir. 2013), in which the court held that certain negative news about a mutual fund's performance which, standing alone, would likely be material, may nonetheless be immaterial where substantial negative news about the fund was already public and had been internalized by the **market**. Id. At 773-74. But the key issue there was not the volume of information available about the fund generally, but rather the "marginal impact that negative nonpubic information would have on an already highly pessimistic public forecast." Id.

The other case cited by DMR was Dep't of **Market** Regulation v. Geraci, Compl. No. CMS020143, 2004 NASD Discip. LEXIS 19 (NAC Dec. 9, 2004). In that disciplinary action brought by DMR's predecessor at NASD, the panel found that merger negotiations concerning a small company whose shares traded over the counter were material, explaining that "even preliminary merger negotiations could be viewed as material, particularly where the corporate entities are small." Id. at *25. But the merger negotiations at issue there were far more advanced than those between Howard and Sillerman - the target company's bankers had been discussing the transaction with the board and management of the acquiring company for two months, including several fullday meetings. Id. at *6-13. Moreover, the panel's decision did not focus on the volume of information available about the company, but rather the likelihood of a completed transaction and the impact it could have on the company's share price. Id. at 25.

Ultimately, the Howard Panel rejected DMR's argument in a single sentence, holding that "Courts do not necessarily assess the volume of publicly available information in assessing the materiality of information about a contingent or speculative event that may or may not occur in the future - such as a potential merger or recapitalization." Decision, at 15.

The balance of the Panel's analysis focused on the preliminary nature of the merger discussions, without regard to the volume of information available about the company itself. Thus, the Panel did not decide that that volume of information was not a factor, or that a dearth of information could support a finding of materiality under certain circumstances; instead, it found that this circumstance did not change the preliminary nature of the information involved, which would not be material under any circumstances.

CONCLUSION

The Howard decision is notable because the Panel had an opportunity to interpret the "total mix" standard of materiality more broadly in the context of non-reporting companies about which the "total mix" of available information is limited. While, ultimately, the Panel did not do so, it also did not issue a clear ruling that the "total mix" standard is applied uniformly when dealing with a reporting company versus a non-reporting shell.

Given the fact that many of these OTC and Pink Sheet cases are being heard before FINRA panels, it appears, for the moment at least, that FINRA may have the opportunity to shape insider trading law in non-reporting companies.

Stanley S. Arkin, a member of this newsletter's Board of Editors, and Lisa C. **Solbakken** are the founding members of Arkin **Solbakken** LLP.