NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF MARKET REGULATION, Complainant, v. JOSEPH A. GERACI, II (CRD No. 2138918), Minneapolis, MN, Respondent.	Disciplinary Proceeding No. CMS020143 Hearing Officer—Andrew H. Perkins **HEARING PANEL DECISION** August 7, 2003

Respondent is barred from the securities industry and fined $15,000 for engaging in insider trading in violation of the antifraud provisions of the securities laws, Section 10(b) of the Exchange Act, and SEC Rule 10b-5 promulgated thereunder, and NASD Conduct Rules 2110 and 2120.

Appearances

For the Department of Market Regulation: Dana R. Pisanelli, Counsel, and Jeffrey K. Stith, Chief Counsel, Litigation, Market Regulation Department, NASD, Rockville, MD.

For the Respondent: Steven E. Rau, FLYNN, GASKINS & BENNETT, L.L.P., Minneapolis, MN.

DECISION

I. INTRODUCTION

The Department of Market Regulation ("Department") brought this disciplinary proceeding against Joseph A. Geraci, II ("Geraci" or the "Respondent"), Thomas D. Krosschell

("Krosschell"), and Troy W. Johnson ("Johnson")[1] based on the Respondents' violations of the antifraud provisions of the securities laws, Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and SEC Rule 10b-5 promulgated thereunder, and NASD Conduct Rules 2110 and 2120.

This disciplinary action arises from the Respondents' purchases of the common stock of Minnesota American, Inc. ("MNAC") in August 1999 shortly before the announcement by MNAC on August 19 that it was negotiating a reverse merger[2] with Berthel Fisher & Co. Financial Services, Inc. ("Berthel Fisher"), an Iowa-based broker-dealer. At the time, each of the Respondents was associated with Maven Securities ("Maven"), a former NASD member firm, which MNAC had retained as its investment banker.

Geraci filed an Answer denying the charges and requesting a hearing. The hearing was held in Minneapolis, Minnesota, on May 7 and 8, 2003, before a Hearing Panel composed of the Hearing Officer, a current member of the NASD District 4 Committee, and a current member of the NASD Market Regulation Committee.[3] The Department called Chad Snyder, a Senior Analyst in NASD Market Regulation assigned to the Insider Trading Section of the Surveillance and Compliance Group, and customer DW, who purchased MNAC stock on the Respondent's recommendation. The Department also introduced 63 exhibits into evidence (Exhibits C1–C56,

[1] Krosschell and Johnson settled the charges against them. Thus, this Decision applies only to Geraci.

[2] A reverse merger, also known as a "backdoor IPO," allows a private company to go public by merging with an existing publicly traded company. The public company usually sells any existing operations, leaving a corporate shell with which the private company can merge.

[3] References to the hearing transcript are cited as "Tr. __." The Department's exhibits are cited as "CX–," and the Respondent's exhibits are cited as "R–."

C58–C62, and C66–C67). The Respondent testified on his own behalf and introduced two exhibits into evidence (R4 and R5).

The case reveals a pattern of self-dealing by Daniel J. Shrader ("Shrader") and Krosschell, the principals of Maven, leading up to the press release on August 19, 1999, announcing that MNAC was working on a reverse merger with a company in the financial services industry. Exploiting their confidential relationship with MNAC, between August 5, 1999, and August 9, 1999, Krosschell and Shrader purchased 104,250 shares of MNAC common stock, which represented nearly two thirds of the total reported volume in MNAC stock for that period. In addition, acting on tips from Krosschell and Shrader, between August 9 and 19, the Respondent and three of the remaining four brokers at Maven purchased MNAC stock for their own accounts. This activity contributed to a significant price increase in MNAC stock, thereby permitting Krosschell and Shrader to sell 38,000 shares of MNAC stock between August 25 and September 7, beginning within hours of the public announcement of the proposed merger, at a total profit of approximately $88,000.

II. FINDINGS OF FACT

A. Background

1. The Respondent

Geraci first became involved in the securities industry in 1991 as a Registered Representative with Van Clemens & Co., Inc., a broker-dealer in Minneapolis, Minnesota, which became Kennedy, Mathews, Landis, Healy & Pecora, Inc.[4] Geraci then worked at R.J. Steichen &

[4] Ex. C2.

Company, Olde Discount Corporation, and Tuschner & Company, Inc. before associating with Maven in August 1999.[5] Maven was a full service brokerage firm headquartered in Minneapolis and an NASD member from June 1988 until October 31, 2000, when it was acquired by Equity Securities Investments, Inc. ("Equity Securities"). Geraci worked at Maven as a General Securities Representative from August 2, 1999, to September 15, 2000.[6] Geraci currently works at Equity Securities in Golden Valley, Minnesota, registered as a General Securities Representative.[7]

2. The Maven Principals

(a) Thomas D. Krosschell

Krosschell was a principal and partner at Maven at all times relevant to this action. He has been registered with NASD as a General Securities Representative since 1990 and as a General Securities Principal since 1994. At Maven, he worked as an investment banker from 1992 to 2000. He is currently registered at Equity Securities.[8]

(b) Daniel J. Shrader

Shrader was registered with NASD as a General Securities Representative and a General Securities Principal from May 1989 through May 2001. During the period relevant to this proceeding, Shrader was Maven's President. He was employed at Maven from June 1989 through

[5] *Id.*

[6] *Id.* at 3.

[7] *Id.* at 1.

[8] Ex. C1.

September 2000 and thereafter at Equity Securities until May 2001. Shrader is no longer registered or associated with a member firm.[9]

B. Origin and Nature of the Underlying Investigation

The Market Regulation Fraud Group received an electronic surveillance alert in August 1999 that identified abnormal price and volume activity in MNAC stock. Upon examination, the Fraud Group noted a news announcement dated August 19, 1999, of a planned reverse merger. Because this appeared to be material news, the Fraud Group referred the matter to the Insider Trading Group for further investigation.[10] Upon receiving the referral, Snyder commenced an investigation to determine if the increased activity in MNAC stock was influenced by knowledge of the anticipated merger.

C. The Proposed Reverse Merger

MNAC was a Minnesota-based holding company with two operating subsidiaries, LockerMate Corporation and Favorite Memories, Inc.[11] The subsidiaries sold school locker organizing systems and school memorabilia organizers.[12] In 1999, MNAC stock traded on the OTC Bulletin Board, but with little daily trading volume or price movement.[13] The average trading volume between January and July 1999 was just 546 shares.[14]

---

[9] Ex. C4. Shrader accepted a permanent bar from associating with any NASD member firm under the terms of his settlement of the charges associated with this disciplinary proceeding.

[10] Tr. 39.

[11] Ex. C6; Tr. 41.

[12] Ex. C6.

[13] Ex. C18; Tr. 62–63.

[14] *Id.*

In January 1999, MNAC's Chairman and Chief Executive Officer, Pierce McNally ("McNally"), met with Krosschell and Shrader at Maven's offices to explore "strategic alternatives" for MNAC.[15] McNally was interested in strategies to increase the price of MNAC stock, but Krosschell and Shrader told McNally that MNAC's business would not garner much public attention because there was a limited market for its products and little growth potential.[16] Kroschell and Shrader therefore recommended that MNAC consider a variety of alternatives, including the sale of its operating subsidiaries. To pursue these alternatives, on February 25, 1999, Krosschell and Shrader, individually, entered into a Financial Consulting Agreement[17] with MNAC in which they agreed to advise MNAC with regard to the sale of its subsidiaries and the evaluation of new strategic business opportunities. Under the terms of the Consulting Agreement, MNAC agreed to compensate Krosschell and Shrader with 300,000 MNAC warrants, exercisable at $0.30 per share, and a cash fee equal to 4% of the sale price of MNAC's subsidiaries.[18]

Krosschell and Shrader first raised the proposal of a reverse merger at a meeting at Maven's offices on July 7, 1999, with McNally and George Wood, an MNAC Director and the Chief Executive Officer of its subsidiaries.[19] Krosschell and Shrader discussed two reverse merger candidates, one of which McNally later learned was Berthel Fisher.[20] After the meeting, McNally

---

[15] Ex. C8.

[16] Ex. C62, at 12 (transcript of Shrader's on-the-record interview).

[17] Ex. C10.

[18] *Id.*, at 2.

[19] Ex. C13 (notes of meeting taken by McNally); Tr. 52–53; Ex. C8, at 1; Ex. C60, at 16–17.

[20] Tr. 54.

authorized Krosschell and Shrader to evaluate reverse merger candidates and find buyers for MNAC's subsidiaries.[21]

In the weeks leading up to Krosschell and Shrader's meeting with representatives of MNAC, they also were talking to representatives of Berthel Fisher about the concept of a reverse merger. Berthel Fisher's president, Ronald Price ("Price"), had contacted Shrader to arrange a meeting to discuss raising funds through a private placement. On June 8, 1999, Krosschell and Shrader met with Price and other Berthel Fisher executives. During this meeting, Shrader asked if Berthel Fisher had ever considered becoming a public company. Krosschell and Shrader explained the benefits of "going public" by way of a reverse merger with a publicly traded company and discussed a recent transaction involving a privately held brokerage firm, Miller, Johnson and Kuehn ("Miller Johnson"), that had reverse merged with NM Holdings.[22] Krosschell followed up with a letter to Price dated June 23, 1999, in which Krosschell reiterated the benefits of a reverse merger to Berthel Fisher and further described the Miller Johnson–NM Holdings reverse merger.[23] Kroschell also wrote that he and Shrader were able "to identify good shell corporation candidates" and that the firm had "close relationships with two publicly-traded shell corporations that have observed and understand the [Miller Johnson–NM Holdings reverse merger] and would be eager to discuss a similar transaction involving Berthel Fisher."[24] The letter however did not mention MNAC.

---

[21] Ex. C60, at 37–38.

[22] Ex. C62, at 19–21.

[23] Ex. C11.

[24] *Id.* at 3.

Krosschell and Shrader then called Thomas J. Berthel ("Berthel"), Chief Executive Officer of Berthel Fisher, to ask if they could meet to discuss the concept of a reverse merger.[25] Berthel invited Krosschell and Shrader to come to Berthel Fisher on July 29, the first day of its scheduled Board of Directors' meeting.[26]

Krosschell and Shrader met with Berthel Fisher's senior management on July 29, 1999, and explained the concept of a reverse merger.[27] The following day, Krosschell and Shrader repeated their presentation to Berthel Fisher's Board of Directors.[28] At the conclusion of their presentation, Berthel Fisher gave Krosschell and Shrader a copy of its most recent audit and shareholder list.[29] At this point, Berthel Fisher referred the issue to its accounting firm to determine if a reverse merger made sense from an accounting perspective.

The following week marked significant progress on the proposed MNAC–Berthel Fisher merger. On August 2, Krosschell and Shrader briefed MNAC on their meetings with Berthel Fisher. Krosschell and Shrader described to McNally the potential merger partner in more detail without identifying Berthel Fisher by name.[30] They gave McNally a general overview of its operations and told him that some of Berthel Fisher's directors were in favor of the proposal. Krosschell and Shrader were sufficiently optimistic about the merger that they raised with

---

[25] Stip. of Berthel's Test. ("Berthel Stip.") ¶ 9

[26] *Id.*

[27] *Id.*; Ex. C20, at 2 (handwritten notes of Ron Brendengen ("Brendergen"), Berthel Fisher's Chief Financial Officer).

[28] Ex. C20, at 2.

[29] *Id.*

[30] Ex. C19, at 3.

McNally adjusting the warrants they had received in February 1999 by reducing the exercise price or increasing the total amount of warrants to be issued.[31] The same day, Brendengen met with Berthel Fisher's accountants to clarify accounting issues related to a potential reverse merger. Brendengen concluded that the reverse merger could move forward.[32]

Moreover, throughout the week of August 2, Krosschell and Shrader continued discussions with Berthel Fisher. Maven's telephone records for this week reflect that there were eight phone calls between Maven and Berthel Fisher.[33] Significantly, during one call, Krosschell and Shrader identified MNAC as the potential merger partner and faxed a MNAC company brochure to Berthel and Brendengen. The parties also discussed a confidentiality agreement and a letter of intent between Berthel Fisher and MNAC. In addition, during this period, Krosschell and Shrader continued to collect information about Berthel Fisher's operations and business relationships, and Shrader requested a blank copy of a confidentiality agreement used by Berthel Fisher.[34]

On Monday, August 9, Berthel Fisher and MNAC signed a Non-Disclosure/Non-Compete Agreement ("Confidentiality Agreement").[35] In the Confidentiality Agreement, MNAC and Berthel Fisher agreed that all information they exchanged would be kept confidential and that,

---

[31] *Id.*

[32] Ex. C20, at 2.

[33] Ex. C12.

[34] Ex. C21; Tr. 69–70; Ex. C20, at 2.

[35] Ex. C22.

without prior written consent, neither party would disclose any information concerning the possible transaction between the two companies.

On August 16, Berthel disclosed MNAC's name to Berthel Fisher's Executive Committee.[36] To this point, only Berthel, Brendengen, and Les Smith, Berthel Fisher's General Counsel, knew of MNAC's identity.

On August 18, Berthel and McNally signed the Letter of Intent on behalf of their respective companies.[37] The Letter of Intent described the terms of the merger, which included share exchange provisions, a corporate name change of the new entity to "Berthel Fisher & Company," and the resignation of the officers and directors of MNAC upon consummation of the transaction. The Letter of Intent called for the reverse merger to be finalized by October 1, 1999.

On August 19, MNAC announced over *Business Wire* that it was working on a reverse merger with an unidentified company in the financial services industry.[38] MNAC released this news with Berthel Fisher's approval because MNAC's attorneys were concerned about the increased trading activity and corresponding increased price of MNAC stock.[39] MNAC stock closed that day at $2.75 on volume of 479,705 shares.[40]

On August 25, 1999, before the market opened, MNAC and Berthel Fisher jointly announced over *Business Wire* that they had executed a Letter of Intent to merge by October 1,

[36] Ex. C20, at 2; Berthel Stip. ¶ 20.

[37] Ex. C48; Ex. C20, at 2.

[38] Ex. C49.

[39] Ex. C20, at 3.

[40] Ex. C31.

1999.[41] The announcement reported that Berthel Fisher would become a public company and that MNAC would sell its current operations. MNAC stock closed that day with a last sale of $3.00 per share on reported volume of 266,976 shares.[42]

The proposed reverse merger between MNAC and Berthel Fisher fell apart in September 1999.[43] MNAC announced the termination on September 17, 1999.[44] MNAC later merged with another company.

D. Purchases of MNAC Stock by Krosschell and Shrader with Inside Knowledge of the Proposed MNAC–Berthel Fisher Merger

Krosschell and Shrader each took advantage of their nonpublic information about the proposed reverse merger between MNAC and Berthel Fisher by purchasing substantial quantities of MNAC stock for their own accounts. Krosschell made an initial purchase of 3500 shares on July 27, 1999, immediately after he and Shrader first met with MNAC to propose the concept of a reverse merger.[45] At his on-the-record interview, Krosschell admitted that he made the purchase primarily because he was encouraged that MNAC had concluded that a reverse merger was worth pursuing and because it had authorized Krosschell and Shrader to look for a merger partner and the price was "reasonable."[46] The Hearing Panel places no weight however on his secondary explanation because MNAC's stock price had been low for many months.

---

[41] Ex. C50.

[42] Ex. C31.

[43] Berthel Stip. ¶ 21.

[44] Ex. C54.

[45] Tr. 59–60. This was just before Krosschell and Shrader's scheduled trip to meet with Berthel and Brendengen at Berthel Fisher's offices to discuss the reverse merger concept with them.

[46] Tr. 60–61.

Between August 5 and 9, as they were negotiating the details of the proposed merger, Krosschell and Shrader purchased 104,250 shares of MNAC stock[47]—two-thirds of the total volume traded on those three days. These purchases also were made using nonpublic information. At the time, only Krosschell, Shrader, and three executives at Berthel Fisher knew that MNAC was the merger candidate.

Krosschell and Shrader finally restricted themselves from further purchases after MNAC and Berthel Fisher signed the Confidentiality Agreement on August 9, 1999. Shrader testified at his on-the-record interview that the execution of the Confidentiality Agreement signified that both companies were serious about going forward with the deal, and Krosschell and Shrader determined that it would be inappropriate to buy more MNAC stock.[48] Yet, Krosschell and Shrader did not place a firm-wide restriction on trading in MNAC stock by all Maven employees, nor did they take any steps to monitor or review trading in MNAC stock by Maven employees before Berthel Fisher and MNAC signed the Letter of Intent on August 18.[49]

On August 25, immediately upon MNAC and Berthel Fisher announcing the execution of the Letter of Intent, Krosschell and Shrader began to sell their MNAC stock.[50] By the time the merger fell apart on September 16, 1999, Krosschell had sold 20,500 shares of MNAC stock in

[47] Stip. Concerning Trading Activity ("Trading Stip.").

[48] Ex. C62, at 52.

[49] Ex. C60, at 54–56.

[50] Tr. 98–99.

his individual account at Maven, realizing a gross profit of $52,219,[51] and Shrader had sold 17,500 shares of MNAC stock in his account at Maven, realizing a profit of about $36,000.[52]

E. Pre-Announcement Purchases by Others at Maven

Four of the five remaining registered representatives at Maven, including the Respondent, either purchased or attempted to purchase MNAC stock before the company's public announcement of the possible merger on August 19. Some also recommended MNAC stock to their family members and friends.

Michael Cain, a sales assistant at Maven, was the first to buy. He purchased 5200 shares on August 9 in his own account and in two accounts he held at Maven for the benefit of his children.[53] Two days later, Johnson recommended MNAC stock to his parents and customer EG.[54] On August 11 and 17, Johnson's parents purchased 35,000 shares of MNAC stock, and EG purchased 50,000 shares.[55] On August 16 and 17, Johnson purchased 25,000 shares of MNAC stock in his joint account at Maven.[56] On August 17, Johnson also recommended MNAC stock to customer DB and his friend KG. DB bought 19,000 shares, and KG bought 5000 shares.[57]

---

[51] Ex. C55, at 1.

[52] Trading Stip. ¶ 16.

[53] *Id.* ¶¶ 5–6.

[54] *Id.* ¶ 7–8.

[55] *Id.* ¶¶ 7–8, 11–12.

[56] *Id.* ¶¶ 9–10.

[57] *Id.* ¶¶ 13–14. Johnson admitted in an on-the-record interview that, in early August 1999, Krosschell and Shrader suggested that he look at MNAC because its share price was moving up. (Ex. C64, at 7–8.)

Issac Sibley ("Sibley"), another Maven registered representative, placed an order to purchase 1000 shares of MNAC stock on August 19, just before MNAC's public announcement of the merger. However, Shrader canceled Sibley's order later that day.[58]

Joseph Stansberry ("Stansberry"), the remaining registered representative at Maven in August 1999 other than the Respondent, admitted that, in June or July 1999, Krosschell told Stansberry that MNAC was a good reverse merger candidate.[59] About one week later, Stansberry passed this information along to a few customers and suggested that they keep track of the stock. Ultimately, three of his customers purchased MNAC stock through another firm.[60] Stansberry did not purchase any MNAC stock because he had no money to invest.[61]

F. Geraci's Pre-Announcement Purchases and Recommendations of MNAC Stock.

Although Geraci did not join Maven until August 2, 1999, his activity in MNAC stock was strikingly similar to that of the other Maven brokers. On August 11, Geraci purchased 5000 shares of MNAC stock for his personal account at Maven and recommended the stock to his girlfriend, KF, who bought 2000 shares in her IRA account at Maven.[62] Geraci also told his father about MNAC, who bought 500 shares on August 11 and another 500 shares on August 16.[63] In addition, on August 17, Geraci recommended MNAC stock to customers DW and SZ. DW

---

[58] Tr. 96; Ex. C47.

[59] Stip. to Testimony of Joseph P. Stansberry ("Stansberry Stip.") ¶¶ 8–9.

[60] *Id.* ¶ 11.

[61] *Id.* ¶ 12.

[62] Tr. 206, 211, 213; Ex. C35; Ex.C58.

[63] Tr. 231; Ex. C58. Geraci's father made both purchases through an on-line broker, not Maven.

testified at the hearing that Geraci recommended MNAC stock because the company was going to be involved in a merger and that, as a result, the price of the stock would rise.[64]

III. CONCLUSIONS OF LAW AND DISCUSSION

A. Jurisdiction

The Respondent is an associated person of a member firm. Accordingly, NASD has jurisdiction of this disciplinary proceeding under The By-Laws of the National Association of Securities Dealers, Inc., Articles XII and XIII.

B. Insider Trading—"Tippee" Liability

The Department charges that the Respondent violated the antifraud provisions of the securities laws, Section 10(b) of the Exchange Act,[65] and SEC Rule 10b-5[66] promulgated

---

[64] Tr. 172–73.

[65] Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), provides in relevant part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange:
>
> ….
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered … any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange Commission] may prescribe as necessary or appropriate in the public interest or for the protection of investors.

[66] The Securities and Exchange Commission (the "Commission") adopted SEC Rule 10b-5 pursuant to its § 10(b) rulemaking authority that similarly provides, in pertinent part:[66]

> It shall be unlawful for any person, directly or indirectly by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (1) To employ any device, scheme, or artifice to defraud,
>
> (2) To make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

thereunder, by trading MNAC stock on inside information tipped to him by Krosschell and Shrader, who held a confidential relationship to MNAC as their investment bankers and consultants. The Department further charges that this same conduct violated NASD's antifraud rule, Conduct Rule 2120, and NASD Conduct Rule 2110, which prohibits members and associated persons from engaging in unethical conduct.

There are two theories of insider trading liability: the "classical theory" and the "misappropriation theory." The classical theory imposes liability on corporate "insiders" who trade on the basis of confidential information obtained by reason of their position with the corporation.[67] The liability is based on the notion that a corporate insider breaches "a ... [duty] of trust and confidence" to the shareholders of his corporation.[68] "Application of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through the fraudulent use of material, nonpublic information."[69] "[T]he classical theory applies not only to officers, directors, and the other permanent insiders of a corporation, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation."[70] Such persons or entities that "enter into a special confidential relationship … and are given access to information solely for

---

(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

[67] In this Decision, the term "confidential information" means "material, nonpublic information."

[68] *United States v. O'Hagan*, 521 U.S. 642, 652 (1997).

[69] *Chiarella v. United States*, 445 U.S. 222, 230 (1980).

[70] *O'Hagan*, 521 U.S. at 652. *See also Dirks v. S.E.C.*, 463 U.S. 646, 655, n. 14 (1983).

corporate purposes" become "temporary" or "quasi" insiders and can be liable for insider trading as if they were permanent insiders.[71] The misappropriation theory, on the other hand, imposes liability on "outsiders" who trade on the basis of confidential information obtained by reason of their relationship with the person possessing such information, usually an insider. The liability under the latter theory is based on the notion that the outsider breaches "a duty of loyalty and confidentiality" to the person who shared the confidential information with him.[72]

Under both theories, the insider and outsider who possess confidential information are forbidden from "tipping" such information to someone else, a "tippee," who trades knowing the confidential nature of the information. The duty of a tippee not to profit from insider information "arises from his role as a participant after the fact in the insider's breach of a fiduciary duty."[73]

To establish the liability of a tippee for insider trading, the Department must show the following five elements: (1) the tipper possessed material, nonpublic information regarding a publicly traded company; (2) the tipper disclosed this information to the tippee; (3) the tippee traded in securities while in possession of the information; (4) the tippee knew or should have known that the tipper had violated a fiduciary duty by providing the information to the tippee; and (5) the tipper benefited from the disclosure of the information to the tippee.[74]

---

[71] *Id.; see also U.S. v. Chestman*, 947 F.2d 551, 565 (2d Cir. 1991) (*en banc), cert denied* 503 U.S. 1004 (1992).

[72] This misappropriation theory "holds that a person commits fraud 'in connection with' a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." A person's "undisclosed, self-serving use of a principal's information to purchase or sell securities" is held to constitute a breach of duty of loyalty and confidentiality. *O'Hagan*, 521 U.S. at 652.

[73] *Chiarella*, 445 U.S. at 230 n.12. However, tippee liability does not depend on the source of the information. *See SEC v. Yun*, 327 F.3d 1263, 1276 (2d Cir. 2003).

[74] *S.E.C. v. Warde*, 151 F.3d 42, 47 (2d Cir. 1998).

C. Krosschell and Shrader Possessed Confidential Information

The Hearing Panel finds that Krosschell and Shrader were MNAC "temporary insiders" due to their "special confidential relationship" with MNAC.[75] Krosschell and Shrader played a central role in bringing MNAC and Berthel Fisher together, and they advised MNAC on many aspects of the proposed reverse merger. In addition, all of the evidence shows that MNAC considered the merger negotiations confidential, and McNally and the other MNAC officers expected that Krosschell and Shrader also would treat the negotiations as confidential. Hence, the merger information qualified as inside information.[76]

The Hearing Panel further finds that the inside information Krosschell and Shrader possessed concerning the MNAC–Berthel Fisher merger negotiations was material because there was "'a substantial likelihood that a reasonable [investor] would consider it important in deciding how to [invest].'"[77] To establish whether the nonpublic disclosure of inside information is material, the Supreme Court has developed a test that examines the effect of disclosure on the reasonable investor. To be material, "[t]he information need not be such that a reasonable investor would necessarily change his investment decision based on the information, as long as a reasonable investor would have viewed it as significantly altering the 'total mix' of information available."[78]

---

[75] *See Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983).

[76] *See, e.g.*, *SEC v. Blackman*, 2000 U.S. Dist. LEXIS 22358 (May 31, 2000) (holding that merger information can qualify as inside information).

[77] *SEC v. Mayhew*, 121 F.3d 44, 51 (2d Cir. 1997) (citations omitted).

[78] *Id.* (citing *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

In *Basic, Inc. v. Levinson*, the Supreme Court applied the foregoing materiality test to a case involving preliminary merger discussions and held that the materiality of a contingent or speculative event, such as a potential merger, depends on "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."[79] There is no fixed rule on when such information becomes material; rather, each case must be decided on its particular facts.[80] "However, because a merger is one of the most important events that can occur for a small company, information regarding a merger 'can become material at an earlier stage than would be the case as regards lesser transactions.'"[81]

Here, the inside information Krosschell and Shrader disclosed had the effect of altering the total mix of information available to the recipients of the information. Without doubt, the prospect of the reverse merger would influence a potential buyer's investment decision. Further, the fact that significant purchases of MNAC stock were made after a history of thin trading in the stock indicates that the information was material.

D. Krosschell and Shrader Tipped Geraci

The circumstantial evidence overwhelmingly supports the conclusion that Krosschell and Shrader tipped information about the negotiations of the reverse merger between MNAC and

[79] 485 U.S. 224, 232 (1988).

[80] *Basic*, 485 U.S. at 238.

[81] *Mayhew*, 121 F.3d at 52 (quoting *SEC v. Geon Indus., Inc.*, 531 F.2d 39, 47 (2d Cir. 1976)).

Berthel Fisher to the other brokers at Maven, including the Respondent.[82] First, Krosschell and Shrader were themselves trading on their confidential information. As discussed above, Krosschell started buying MNAC stock immediately after he and Shrader first met with MNAC to propose the concept of a reverse merger. Indeed, Krosschell admitted that he made his purchase because he was encouraged that MNAC had authorized Krosschell and Shrader to look for a merger candidate. Second, Krosschell and Shrader knew that the Maven brokers were buying MNAC stock in early August. This fact is evidenced by Krosschell's on-the-record interview testimony that Krosschell and Shrader told the brokers to discontinue purchasing the stock sometime between August 17 and 19. Third, Krosschell and Shrader did not place a firm-wide restriction on the Maven brokers at the time they determined that they should not themselves continue to profit directly through further accumulation of the stock in their own accounts. Fourth, Krosschell and Shrader began to sell the stock immediately after the companies announced they had signed the Letter of Intent to merge. Fifth, the Respondent stipulated that Krosschell told Stansberry to look at MNAC as a good merger candidate, and Stansberry passed this information on to two customers who then purchased MNAC stock. And sixth, the brokers' trading pattern in MNAC stock in early August supports the conclusion that Krosschell and Shrader had tipped them with information about MNAC's merger plans.[83] Once the Confidentiality Agreement was signed on August 9, Shrader and Cain immediately purchased

[82] *Cf. In the Matter of Eng*, 53 S.E.C. 709 (1998) (holding that circumstantial evidence is sufficient to support a finding of insider trading).

[83] *Cf. Warde*, 151 F.3d at 48 (holding that a pattern of parallel trading in a risky investment is circumstantial evidence of the disclosure of material, nonpublic information).

MNAC stock for their own accounts. Then, Geraci and Johnson each made purchases on August 11 and 17, just before MNAC and Berthel Fisher signed the Letter of Intent and Krosschell and Shrader stopped further purchases.

Geraci contends, on the other hand, that all of these factors are coincidental. At the hearing, Geraci maintained that he discovered MNAC on his own after he joined Maven on August 2. Geraci testified that he became interested in MNAC after he reviewed either its annual report or a research report on the company.[84] Geraci also contended that it was the "hockey stick" price/volume chart that caught his attention.[85] Geraci explained that he typically liked to invest in speculative companies that have experienced a sharp upswing in reported price and volume, which, when charted, forms a flat then abrupt upward pattern.[86] Geraci disputed that Krosschell, Shrader, or anyone else at Maven gave him confidential information about MNAC's merger negotiations.[87] In fact, Geraci claimed that he had no knowledge of Maven's engagement to assist MNAC or the purchases made by Krosschell, Shrader, Crain, and Johnson. He also disavowed any knowledge about MNAC from outside Maven. He testified that he had not heard any rumors about the planned merger.[88]

[84] Tr. 216.

[85] *Id.* at 213–14.

[86] *Id.* at 227.

[87] *Id.* at 217–18.

[88] Tr. 219–20.

Geraci's explanation of his purchases of MNAC stock is unsupported by the other evidence. First, the price/volume chart[89] for MNAC does not reflect the type of activity he described for the period between August 2, when he joined Maven, and August 11, when he first purchased MNAC stock. While it is true that the volume spiked to 523,429 shares on August 11, this could not have factored into his decision to buy MNAC stock because he placed his order just 15 minutes after the market opened.[90] The ultimate dramatic volume that day came after he placed his order. Second, Geraci's claim that he researched the stock before he made his initial purchase on August 11 and that he may have gotten the reports off the Internet[91] is undermined by his admission that he did not have the necessary tools available to do independent research at that time. Geraci admitted at the hearing that he did not have Internet access at the office.[92] In his own words, Maven's system was very basic; "it was by no means a Bloomberg system."[93]

Customer DW's testimony corroborates the Hearing Panel's finding. DW testified that Geraci told him on August 17—two days before the public announcement of the merger—that MNAC was going to be involved in a merger and that DW should therefore purchase MNAC stock because its price would go up as a result.[94] There is no evidence discrediting DW's recollection of this conversation, and his decision to purchase the stock is consistent with other investment decisions DW made in reliance on Geraci's recommendations.

---

[89] Ex. C18, at 3.

[90] Tr. 213; Ex. C35, at 1.

[91] *Id.* at 235.

[92] *Id.* at 237.

[93] *Id.* at 238.

E. Geraci Acted with Scienter

The Hearing Panel also finds that Geraci acted with scienter.[95] Geraci knew or should have known that Krosschell and Shrader had breached their duty to MNAC by disclosing material, nonpublic information about the reverse merger. The Hearing Panel rests this finding on the combination of several factors. First, Geraci was an experienced securities professional.[96] As such, he knew or should have known that information of the type he learned at Maven about the merger negotiations between MNAC and Berthel Fisher was routinely treated as confidential. Second, Geraci knew Krosschell and Shrader before he joined Maven,[97] and Geraci was good friends with Johnson, with whom he owned a bar and restaurant, and Sibley, who was his roommate several years before Geraci joined Maven.[98] From these friendships and business relationships the Hearing Panel infers that Geraci knew of the relationship between MNAC and Maven in early August 1999 and that Krosschell and Shrader stood in a position of trust with respect to MNAC.[99] Third, the high degree of materiality or importance of the information leads to the conclusion that Geraci was aware that Krosschell and Shrader were breaching a duty to MNAC by disclosing the information before the public announcement.[100] Finally, Geraci's advice to his father and girlfriend

---

[94] Tr. 172–73.

[95] Scienter is defined as "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

[96] *SEC v. Ingram*, 694 F. Supp. 1437, 1441 (C.D. Cal. 1988).

[97] Tr. 197.

[98] *Id.* at 195–96.

[99] *Cf. Warde*, 151 F.3d at 48 (considering relationship between tipper and tippee).

[100] *Cf. Ingram*, 694 F. Supp. at 1441, n.5 (considering the materiality of the information as one objective indicia of the defendant's state of mind).

to purchase MNAC stock before the public announcement of the merger manifests Geraci's awareness of the importance and timeliness of the information.[101]

F. Benefit to Krosschell and Shrader

"The showing needed to prove an intent to benefit is not extensive."[102] In *Dirks,* the Supreme Court defined "benefit" in very expansive terms.[103] The Department does not need to show that Krosschell and Shrader expected or received a specific or tangible benefit. "Rather, the 'benefit' element of § 10(b) is satisfied when the tipper 'intends to benefit the … recipient' or 'makes a gift of the confidential information to a trading relative or friend.'"[104]

Here, the evidence shows that Krosschell and Shrader intended to benefit directly and from the disclosure. By maximizing the market activity in MNAC stock in the period leading up to the merger announcement, Krosschell and Shrader knew that they would increase their profit on the stock they purchased in their own accounts in anticipation of the merger announcement. In addition, Krosschell and Shrader intended to benefit by sharing this information with their brokers. This evidence meets the controlling standard.

G. Geraci's Credibility

The Hearing Panel's findings are influenced greatly by its view of Geraci's total lack of credibility. Although Geraci admitted that he first heard about MNAC after he joined Maven on

---

[101] *Blackman*, 2000 U.S. Dist. LEXIS 22358, at *22–23.

[102] *Yun*, 327 F.3d at 1280.

[103] *Dirks v. SEC*, 463 U.S. at 663–64.

[104] *Warde,* 153 F.3d at 48 (quoting Dirks, 463 U.S. at 664).

August 2,[105] he claimed not to have discussed MNAC with Krosschell, Shrader, or any of the other brokers who were buying, or attempting to buy, MNAC stock.[106] He just remembers hearing the name MNAC, but not who mentioned it.[107] The Hearing Panel finds this testimony unbelievable. Geraci admitted that he had a long-standing relationship with Maven and many of the brokers at Maven, including Krosschell and Shrader. Geraci had participated in private placements with Shrader before joining Maven, and he and Krosschell were friends. In his on-the-record interview testimony, Geraci testified that he joined Maven because "I knew [Krosschell and Shrader] and I knew that they—that the firm was an investment banking firm, and that's where my interest lies."[108] Under these circumstances, it is not believable that Krosschell and Shrader did not tell their friend and business associate about their investment banking work for MNAC.

It also is unlikely that none of the other brokers mentioned that they were buying MNAC because it was in play due to the merger discussions. Most significantly, Geraci and Johnson shared a small office and a computer terminal. Their desks were only a few feet away, and Geraci could overhear Johnson's telephone conversations with his customers.[109] In addition, Johnson and Geraci made purchases on the same days. Indeed, on August 17, they were both entering orders at the same time, which required Geraci to telephone his orders into the clearing firm because

[105] Tr. 210, 217.

[106] *Id.* at 194–95.

[107] *Id.* at 212.

[108] *Id.* at 112.

[109] *Id.* at 122.

Johnson was using the terminal in their office.[110] Geraci's claim that he entered these purchases without any knowledge of Johnson's activity is unbelievable.

H. Conclusion

For the foregoing reasons, the Hearing Panel finds that Geraci engaged in insider trading in violation of the antifraud provisions of the securities laws, Section 10(b) of the Exchange Act and SEC Rule 10b-5 promulgated thereunder, and NASD Conduct Rules 2110 and 2120.

IV. SANCTIONS

In light of the egregious nature of Geraci's misconduct and to protect the public interest, the Department seeks an order barring Geraci from association with any NASD member firm. The Department notes that although the NASD Sanction Guidelines ("Guidelines") do not provide recommended sanctions for insider trading, the Guidelines do contain generic recommendations for misrepresentations and omissions of material facts, in violation of NASD Rules 2110 and 2120.[111] The Guideline provides for a suspension of up to two years and a fine of $10,000 to $100,000 for intentional or reckless misconduct. In egregious cases, the Guideline recommends consideration of a bar.[112]

The Hearing Panel agrees with the Department's assessment of the seriousness of Geraci's misconduct and the risk he poses to the investing public should he be permitted to remain in the securities industry. Geraci, a twelve-year veteran of the securities industry, well knew that trading on inside information violated the securities laws and NASD's conduct rules. Nevertheless, he

[110] *Id.* at 119–21.

[111] NASD Sanction Guidelines 96 (2001 ed.)

joined in the fervor to personally benefit before MNAC announced its intention to merge with Berthel Fisher. Geraci can point to no credible explanation for his sudden interest in MNAC upon joining Maven, nor can he provide a reasonable and credible explanation for his parallel trading pattern to Johnson's, his friend, business partner, and officemate. Moreover, Geraci's lack of candor regarding his participation in the insider trading at Maven brings into question his fitness as a securities professional and reflects a high degree of scienter.[113]

Ultimately, the question for the Hearing Panel is whether the sanctions sought are appropriately remedial and are "tailored to address the misconduct involved in each particular case."[114] Under the facts and circumstances of this case, the Hearing Panel concludes that Geraci cannot continue to operate in the securities industry. Accordingly, the Hearing Panel will bar him from associating with any member firm in any capacity.

In addition, the Hearing Panel finds that a fine of $15,000 is appropriate to assure that he and his tippees do not profit from his wrongdoing.[115] However, in light of the bar, payment of the fine shall be due and payable if and when Geraci re-enters the securities industry.

V. ORDER

Therefore, having considered all the evidence,[116] the Hearing Panel orders that Respondent Joseph A. Geraci, II is barred from association with any member firm in any capacity and fined $15,000, which fine shall be due and payable if and when he re-enters the securities industry.

---

[112] *Id.*

[113] *See, e.g., Market Reg. Comm. V. Eng*, No. CMS940041, 1997 NASD Discip. LEXIS 26, at *62 (Apr. 14, 1997).

[114] Guidelines, General Principles No. 3, at 4.

[115] *See, e.g., Eng*, 1997 NASD Discip. LEXIS 26, at *64.

Geraci also is ordered to pay costs in the total amount of $2,160.83, which include an administrative fee of $750 and hearing transcript costs of $1,410.83.

These sanctions shall become effective on a date set by the NASD, but not sooner than 30 days from the date this Decision becomes the final disciplinary action of the NASD, except that if this Decision becomes the final disciplinary action of NASD, the bar shall become effective immediately.

_____

Andrew H. Perkins
Hearing Officer
For the Hearing Panel

Copies to:

Joseph A. Geraci, II (by overnight courier and first-class mail)
Steven E. Rau, Esq. (by facsimile and first-class mail)
Dana R. Pisanelli, Esq. (by first-class and electronic mail)
Jeffrey K. Stith, Esq. (by first-class and electronic mail)

[116] The Hearing Panel has considered all of the arguments of the Parties. They are rejected or sustained to the extent they are inconsistent or in accord with the views expressed herein.