FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. HARRY FRIEDMAN (CRD No. 2548017), and JOSEPH SCHNAIER (CRD No. 2656314), Respondents.	Disciplinary Proceeding No. 2005000835801 Hearing Officer – LBB **HEARING PANEL DECISION** May 8, 2009

For purchasing and selling securities without prior written notice to their firm in violation of Conduct Rules 3040 and 2110, Respondent Harry Friedman is suspended in all capacities for 45 days, and Respondent Joseph Schnaier is suspended in all capacities for 90 days. In addition, each Respondent is fined $77,500. Respondents are also assessed costs.

Appearances

For the Department of Enforcement, Hugh C. Patton, Regional Counsel, and Jeffrey Kern, Senior Regional Counsel, New York, New York

For Respondents, Brian H. Reis, New York, New York

DECISION

The Complaint in this matter was filed on November 15, 2007, charging Respondents Harry Friedman and Joseph Schnaier ("Respondents") with violating NASD Conduct Rules 3040 and 2110 by participating in private securities transactions for compensation, by purchasing and selling shares of a video game company, while associated with First Montauk Securities Corp., a

FINRA member firm, without providing written notice or obtaining prior written approval.[1] The Hearing Panel finds that Respondents violated Rules 3040 and 2110 by purchasing the shares and selling some of them a few months later, without providing written notice to their firm before engaging in the transactions.

At the hearing in New York City, the Department of Enforcement called six witnesses in its case-in-chief, and Respondents called three witnesses in their case-in-defense. In addition, the Hearing Panel called two witnesses who had been associated with Respondents' former firm to testify concerning the production of documents by the firm prior to the issuance of the Complaint, and the search for additional documents requested pursuant to an order of the Hearing Panel.[2]

I. Findings of Fact

A. Respondents

Respondent Harry Friedman first became registered with FINRA as a General Securities Representative ("GSR") in October 1994 through a member firm, and has been continuously

[1] As of July 30, 2007, NASD consolidated with the member regulation and enforcement functions of NYSE Regulation and began operating under a new corporate name, the Financial Industry Regulatory Authority ("FINRA"). References in this decision to FINRA include, where appropriate, NASD. Following consolidation, FINRA began developing a new FINRA "Consolidated Rulebook." The first phase of the new consolidated rules became effective on December 15, 2008, including certain conduct rules and procedural rules. *See* Regulatory Notice 08-57 (Oct. 2008). This decision refers to and relies on the NASD Conduct Rules that were in effect at the time of Respondents' alleged misconduct. In addition, because the Complaint was filed before December 15, 2008, the NASD Procedural Rules were applied in this disciplinary proceeding. Effective December 15, 2008, Conduct Rule 2110 was incorporated into the FINRA Consolidated Rules as FINRA Conduct Rule 2010, without substantive change. *See* NTM 08-57.

[2] As evidence that the firm did not receive any written notices from Respondents or grant written permission, Enforcement offered the firm's written response to the staff's pre-Complaint request for documents and information concerning Respondents' compliance with Rule 3040. The Hearing Panel believed that it would be helpful to hear testimony from the firm about the scope of the search conducted in response to the Rule 8210 request, the firm's diligence in conducting the search, and the firm's recordkeeping practices. The Hearing Panel also broadened the scope of the documents requested from the firm, to determine whether Respondents had provided any written information about the transactions to their firm. Neither Respondents nor Enforcement objected to calling the witnesses. First Montauk did not produce any additional documents in response to the Hearing Panel's request.

registered with FINRA since then. Stip. 1; CX-1.[3] On October 24, 2002, Friedman executed an Independent Contractor Affiliate Agreement with First Montauk Securities Corp. to operate a franchise office as an Office of Supervisory Jurisdiction in New York City. Friedman began working at First Montauk on October 29, 2002, and was the branch office manager. Stip. 8. From November 8, 2002, to July 13, 2004, he was registered through First Montauk as a GSR and a General Securities Principal ("GSP"). Stip. 2; CX-1. Since May 22, 2006, Friedman has been registered through another member firm as a GSR and GSP. Stip. 3; CX-1.

Respondent Joseph Schnaier first became registered with FINRA as a GSR in November 1995 through a member firm, and was continuously registered with FINRA until January 2, 2008. Stip. 4, 6; CX-2. From November 6, 2002, to July 7, 2004, Schnaier was registered through First Montauk as a GSR. Stip. 5, 8; CX-2. Schnaier has not been registered with a FINRA member firm since January 2, 2008. Stip. 6; CX-2; Tr. 724 – 725.

At all times relevant to the Complaint, Friedman and Schnaier each owned 50 percent of Global International Services, LLC ("Global"), a company they formed on the advice of Friedman's accountant. Respondents deposited their revenues into the Global bank account, and Global paid the expenses of the First Montauk OSJ that Friedman managed. Stip. 9; Tr. 890 – 891.

B. The Majesco Transactions

In January 2003, a friend of Schnaier's called him from the consumer electronics show, a trade show in Las Vegas, to tell him about Majesco Sales, Inc. ("Majesco"), a private company incorporated in 1986. Majesco, located in Edison, New Jersey, was a provider of video game

[3] References to the testimony set forth in the transcripts of the hearing are designated as "Tr. __," with the appropriate page number. References to the exhibits provided by the Department of Enforcement are designated as "CX-___," and Respondents' exhibits are designated as "RX-___." The parties filed stipulations on September 19, 2008. Stipulations are designated as "Stip. ___."

and digital entertainment products. Stip. 10; Tr. 627 – 628, 651. Schnaier thought the video game industry was "hot," and that Majesco was an interesting opportunity. He hoped to bring Majesco to First Montauk as an investment banking client. Tr. 211 – 214, 651 – 655, 907 – 908. Schnaier contacted Majesco, and Respondents visited Majesco at its location in New Jersey. Stip. 12; Tr. 627 – 628, 651, 949.

Schnaier did not succeed in getting Majesco's investment banking business. He introduced the family who owned Majesco to another firm, which "backfired" because the other firm ended up doing Majesco's investment banking. The family offered Respondents the opportunity to buy stock in Majesco, and, in the fall of 2003, they agreed to buy a total of 2.5 million shares of Majesco for $25,000, or a penny a share, from four members of the family. Tr. 662 – 663, 956. On October 15, 2003, a press release announced that Majesco would merge with ConnectivCorp, a publicly traded company. Tr. 398 – 399. Global, Respondents' company, bought the shares on November 27, 2003, at the agreed price of a penny a share. Stip. 11; CX-30 at 9; Tr. 928 – 929, 931 – 932.

On December 5, 2003, eight days after Global bought its shares in Majesco, the company completed a reverse merger with ConnectivCorp, then a publicly traded company with no active operations. ConnectivCorp later changed its name to Majestic Holdings, Inc. Stip. 13, 14. On the day of the merger, the stock opened at $1.01 per share and closed at $1.05. Tr. 398 – 400. Although Majesco had nearly $50 million in sales in 2002 and 2003, and $120 million in sales in 2004, it incurred losses in 2002, and substantial losses in 2003 and 2004. Tr. 402 – 403.

At the time of the Majesco purchase, Respondents did not intend to sell the shares. Not long after the purchase and the reverse merger with ConnectivCorp, however, Schnaier was contacted by Trinad Capital ("Trinad"), a hedge fund that was Majesco's largest shareholder, and

that had been involved in Majesco's investment banking transactions, which offered to buy all of Respondents' Majesco shares. Tr. 662 – 664, 718, 931 – 932; CX-30 at 8, 14. Respondents had no prior relationship with Trinad, which was introduced to Majesco's original owners by the firm that handled Majesco's investment banking. Tr. 662 – 663. Respondents agreed to sell one million Majesco shares to Trinad at $1.25 per share, a substantial discount from the market price. Tr. 932.

At this time, Respondents were trying to coax Joel Gold, an investment banker with another firm, to join the new broker-dealer they were trying to form. As part of their effort to build a relationship with Gold, they decided to sell some of their Majesco shares to Gold at the same price they had received from Trinad. Tr. 933 – 934; CX-4. Gold was interested in Majesco because his former firm had also tried to get investment banking business from Majesco. Tr. 716 – 717. In addition, Friedman approached R.G., a family friend of Friedman's and a customer of Friedman's and the firm's, to offer her the opportunity to invest. R.G. was a wealthy investor who managed a substantial amount of New York real estate. She had lost a substantial amount of money with a previous broker, and Friedman thought he could help her to recoup her losses by selling her some of the Majesco shares at a substantial discount, in the range of the price Respondents were to receive from Trinad. Tr. 933 – 935; Stip. 16; CX-31 at 10.

On April 15, 2004, Global sold 100,000 Majesco shares to Joel Gold at $1.25 per share. On April 20, 2004, Global sold 75,000 shares to R.G. at $1.40 per share. On May 24, 2004, Global sold one million shares to Trinad at $1.25 per share. CX-3; CX-4; Stip. 15 – 17. The share prices negotiated between Global and the three buyers were lower than the market price prevailing at the time – which ranged from $3.00 to $3.50 during April and May 2004 – in part

because the shares were subject to a lock-up agreement and could not be sold for at least a year after the first registration statement. Stip. 18; Tr. 710, 716, 718, 930 – 932; CX-4; CX-30 at 15.

All told, Respondents received $1,493,250 for Global's sale of 1,175,000 shares of Majesco to the three purchasers. Stip. 20. Their profit on the shares sold was $1,481,500. The proceeds went to Global, effectively going equally to each Respondent. They retained 1,325,000 shares of Majesco. Stip. 20; Tr. 713 – 714, 935, 963 – 964.

C. Respondents Told First Montauk About the Majesco Opportunity, but Did Not Provide Written Notice to the Firm or Receive Approval from the Firm

The Hearing Panel finds that Respondents discussed engaging in a Majesco transaction with First Montauk, but they did not provide written notice to their firm, or receive written approval, before they bought or sold their stock.

1. Respondents Discussed Engaging in a Transaction Involving Majesco with Their Firm

As discussed above, Respondents' goal was to bring Majesco to First Montauk as an investment banking client. First Montauk required that all investment banking opportunities be reviewed and monitored by the corporate finance department. Tr. 211 – 214. Schnaier met with Ernest Pellegrino, First Montauk's director of corporate finance, to discuss Majesco as an investment banking opportunity, but Pellegrino did not offer enthusiastic support. He was, in Schnaier's words, "standoffish." Schnaier and Pellegrino disagreed about the percentage of the commissions that would go to Schnaier.[4] Pellegrino said that if Schnaier had a problem with the payout structure, he should talk to Herbert Kurinsky ("Kurinsky"),[5] First Montauk's president and CEO. Tr. 655 – 656.

[4] Pellegrino did not recall that there were any conversations concerning Majesco, but did not deny that there could have been such conversations. Tr. 242, 250, 254 – 255, 278.

[5] All references to "Kurinsky" refer to Herbert Kurinsky, except where the discussion specifically refers to Bill Kurinsky, a senior executive at First Montauk.

Schnaier then called Ken Norensberg, a vice president of business development, who served as a recruiter and branch manager for First Montauk, and who had brought Friedman and Schnaier into the firm. Schnaier suggested to Norensberg that there should be a meeting with Herbert Kurinsky about the Majesco opportunity. Tr. 250, 651 – 656. As a result of the call, Schnaier, Friedman, Norensberg, Herbert Kurinsky, and Bill Kurinsky, a senior executive at the firm, met at First Montauk's headquarters in Red Bank, New Jersey, to discuss the potential investment banking transaction with Majesco. Tr. 563 – 564.[6]

Schnaier and Norensberg testified that Schnaier said at the meeting in Red Bank that his intentions included taking the company public, buying shares, and selling shares of the company. Tr. 598 – 599, 612, 630 – 632, 727 – 728.[7] Although Norensberg testified that Herbert Kurinsky told Schnaier to do whatever Schnaier wanted to do, including buying the Majesco shares, the Hearing Panel did not find it credible that Kurinsky gave Schnaier such blanket approval. Tr. 570. This testimony conflicts with Friedman's testimony that Respondents did not intend to sell the shares at the time Respondents bought them. It also is unlikely that a discussion about payouts on the investment banking opportunity would lead to a discussion of purchasing and selling shares, especially since, as Friedman testified, the focus of the meeting was more on overall investment banking issues than on a specific transaction. Tr. 913 – 914. The Hearing

[6] The Department of Enforcement concedes that it is "plausible" that Respondents discussed Majesco with Herbert Kurinsky, the president of their firm, as an investment banking opportunity. Department of Enforcement's Post-Hearing Brief at page 12. Kurinsky, who is retired and has some memory problems, testified that he did not remember whether he had ever discussed Majesco with Respondents. Kurinsky struggled to remember specific events and people, but was generally unable to do so. Because of his lack of memory about specific events and people, the Hearing Panel finds that Kurinsky, while forthright, was not a reliable witness concerning his contacts with Respondents. Tr. 186 – 187, 191.

[7] Although they regarded themselves as partners, Respondents operated their respective parts of the business independently. Friedman concentrated on the brokerage part of the business, and was largely unaware of developments in Schnaier's investment banking business. He recalls a discussion in the Red Bank headquarters of the payouts for the Majesco investment banking opportunity, but left the room during at least one meeting in Red Bank when Schnaier may have discussed Majesco with Kurinsky. Tr. 952 – 958. Schnaier testified that part of his discussion of Majesco with Kurinsky occurred when everybody else was out of the room. Tr. 728.

Panel also did not find Norensberg to be a credible witness. He is a close friend of Friedman's, and appeared to the Panel to be an advocate for Respondents. The Hearing Panel finds that there was such a meeting concerning investment banking issues, but there was not a detailed discussion of the possibility of buying stock, nor did Herbert Kurinsky grant permission to Respondents to purchase or sell the Majesco shares.

Schnaier and Norensberg testified to other communications with the firm concerning the purchase and sale of the shares. Schnaier told Norensberg that he intended to buy and sell the shares. Tr. 565 – 568. Norensberg testified that others within the firm, including Steve Gurstel, the regional supervisor, were aware of the purchase of the shares, but he did not testify that Respondents provided any detail to Gurstel or told him of the sale of the shares. Tr. 595, 606 – 608. Gurstel did not testify at the hearing. The Hearing Panel does not find it credible that Respondents told Gurstel about the purchase of the shares. Respondents did not testify that they said anything to Gurstel at their OTRs or at the hearing, and they presumably would have mentioned such a discussion. It also would not be reasonable to tell Gurstel about the transactions, yet not to provide written notice to anyone. Additionally, if Gurstel, their supervisor, had been informed of the transactions, he would likely have reminded Respondents of their obligations with respect to written notice, and requested copies, but Schnaier did not testify that Gurstel received a copy of the written notice.

Schnaier testified that he discussed both the purchase and sale of the shares with Kurinsky in telephone conversations. Tr. 680 – 683. Schnaier does not remember the details of the conversations, but testified that he told Kurinsky that he had the opportunity "to buy shares in a private company very cheap." He testified that when the opportunity to sell the shares arose, he again called Kurinsky and said that they had an opportunity to sell some of their shares.

Tr. 667 – 677, 680 – 682. Schnaier's testimony concerning these conversations was not credible.[8] Schnaier never mentioned the calls during FINRA's Membership Application Program ("MAP") interview and review process, discussed below, despite a strong incentive to persuade the MAP examiners of his diligence in notifying the firm and receipt of the firm's approval. In addition, the Hearing Panel did not find Schnaier to be a credible witness overall. He was frequently combative and evasive on cross-examination, often seeming to prefer showing his disdain for the Enforcement attorneys rather than answering questions directly.

2. Respondents Did Not Submit Written Notice of Their Intention to Purchase or Sell Majesco Stock to Their Firm

Schnaier testified that he provided written notice on behalf of both Respondents directly to Herbert Kurinsky before both the purchase and the sale of Majesco stock, and that he received written permission for both sets of transactions directly from Kurinsky. Tr. 633 – 634, 675 – 683, 868 – 869.[9] Schnaier's testimony was not credible. There is no evidence to corroborate Schnaier's contentions, but there is substantial evidence that suggests that notices were never sent to First Montauk.

First Montauk has no record of receiving a notice from either Respondent, or of sending written approval of either the purchase or sale. The firm was diligent about saving such documents, and conducted diligent searches for the documents, but found none. CX-12; Tr. 320 – 321, 745 – 753, 761 – 765, 768 – 770, 808 – 809, 812 – 815, 846 – 847. Furthermore, approving such a request would have been contrary to Kurinsky's usual practice of not approving

[8] Because of Kurinsky's memory problems, the Hearing Panel does not rely on his testimony concerning specific conversations, or the absence of such conversations.

[9] Friedman did not obtain permission from First Montauk for the purchase or the sale of Majesco shares. Tr. 916 – 917, 979 – 980. Friedman was not aware of the alleged notice until shortly before Schnaier's on-the-record interview ("OTR") in connection with the investigation that led to the filing of the Complaint. Tr. 923 – 926.

requests from representatives, but referring such requests to the appropriate person within the firm, generally the compliance department. Tr. 188 – 189, 191, 314, 316, 331 – 333, 822, 856.[10]

Respondents also have not produced copies of the alleged notices or approvals, alleging that the notices and approvals no longer exist. They explain the absence of the records primarily by asserting that a "flood" in their offices destroyed both paper and electronic files. CX-10; Tr. 635, 722 – 723, 936 – 938, 990, 992 – 994. The evidence does not support this assertion. When Schnaier testified at his OTR on April 18, 2007, he offered to search for the written notices and approvals, but he did not mention a flood, or any other problems with the integrity of his paper or electronic records. CX-30 at 3, 16, 28. It is not credible that he would fail to mention the destruction of both computer and paper records, and offer to conduct a search, when testifying in an investigation of whether he gave proper written notice.

Schnaier's assertion that he gave written notice and received written approval from Kurinsky is also inconsistent with Respondents' representations to FINRA prior to the commencement of FINRA's investigation. Respondents had several communications with FINRA in which the issue of notice of the transactions to First Montauk was raised, but the first time Respondents asserted to FINRA that Schnaier had allegedly submitted written notices to First Montauk and received permission was in Schnaier's testimony at an OTR on April 18, 2007. Tr. 416, 704 – 705.

In 2004, Respondents submitted a new member application to FINRA, proposing to form a new broker-dealer that would be called Friedman Schnaier & Associates. Tr. 34 – 36, 918. Respondents and their consultant for the application process were interviewed by an examiner

[10] Kurinsky's memory was clearer on general practices than on specific events. His testimony on this issue was consistent with the testimony of other witnesses, and the testimony of the other witnesses was sufficient to establish Mr. Kurinsky's practices.

and an examination manager from FINRA's MAP Department on November 17, 2004. One of the topics of discussion was the source of funding for their proposed new broker-dealer. In particular, MAP wanted information about two substantial deposits in Respondents' bank accounts. Tr. 40, 42, 463 – 465. Friedman described the Majesco stock transactions, and explained that the deposits related to the sale of the Majesco stock. In response, FINRA's examination manager discussed Rule 3040, informing Respondents that the rule would have required notice to First Montauk prior to the purchase and sale of Majesco stock. Tr. 50 – 51, 469 – 471, 473, 475, 505, 972 – 973. Friedman said he was not aware that they needed to comply with the rule, and that Respondents had not submitted notices to First Montauk. The examiner again mentioned the issue in the wrap-up to the meeting. Schnaier was present, but said very little during the meeting. He said nothing about whether Respondents had notified First Montauk of the Majesco transactions. Tr. 52 – 53, 55 – 57, 105 – 108, 113, 475 – 479, 502 – 503, 972 – 973.

On December 17, 2004, the consultant responded to written questions from the examiner, copying Friedman on the correspondence. CX-3. The response stated that Respondents had not notified First Montauk of the purchase or sale because they did not know that notification was required. "It was the understanding of the owners of Global International Services, LLC that there was no need to inform First Montauk – partly owing to the fact that Global was engaged in a passive investment wherein the owners of Global had no active role in such an investment." CX-3. The response also stated that Respondents did not receive a letter from First Montauk authorizing them to engage in the transactions. CX-3 at p. 4; *see also* Tr. 977 – 979.

On January 5, 2005, Friedman, the consultant, and the two FINRA MAP examiners held a telephone conference concerning Respondents' application to register their new broker-dealer.

The examination manager said she had serious concerns about the viability of the application due to the apparent Rule 3040 violations, and that she would be referring the potential Rule 3040 violations to the cause department for further investigation. Tr. 65 – 66, 482 – 483, 520 – 521, 985, 996.[11] Nine days later, the consultant responded to further questions from FINRA, and reiterated that Respondents did not notify First Montauk of the transactions "because of the nature of the investment." Further, the response stated, "Mr. Friedman admits that it might have possibly been a mistake in hindsight." CX-4. Respondents eventually withdrew their application to form a new broker-dealer. Tr. 515 – 516.

Respondents also failed to mention the alleged written notices and approvals at a meeting with the MAP department just a few weeks before Respondents' OTRs. Respondents met with the MAP department in March 2007 in connection with their application to increase their ownership of the broker-dealer they joined after leaving First Montauk. The MAP examiners told them that the status of the investigation of their compliance with Rule 3040 could affect their application. Tr. 488 – 497. Yet, as noted above, the first time Respondents asserted that notices were given and approvals were received was at Schnaier's OTR.

Respondents explain their repeated failure to inform FINRA's MAP examiners of Schnaier's notices to First Montauk and First Montauk's approvals by explaining that Schnaier was only minimally involved in the MAP process, Schnaier was too shy or intimidated by the interview process to speak up, and that they did not discuss the issue between themselves because they did not appreciate its importance. The shyness explanation is not credible. It was clear at the hearing that Schnaier is not bashful about speaking his mind, and is assertive, and often blunt and argumentative, in expressing his views. Norensberg confirmed the Hearing

[11] The investigation in this matter started as a result of the referral from the MAP Department. Tr. 99, 404.

Panel's observation of Schnaier's lack of shyness. Tr. 562, 568 – 569, 591. Respondents' argument that they did not realize that there was a serious issue is also not credible. Schnaier testified that he does not even remember a discussion of the notices and Rule 3040 issue at the MAP interviews, and if there was a discussion, that the examiners "never made an issue out of it." Tr. 692 – 693, 861 – 862. Friedman says the issues were raised "matter-of-factly" among numerous issues that were raised. Tr. 923, 974 – 975.[12] It is not credible that Schnaier would have sat silent while Friedman told two FINRA examiners that Respondents had not notified First Montauk of their purchase and sales of Majesco sales, especially since Schnaier testified that he was aware of the written notice requirements, and the FINRA examiners told Respondents that their failure to provide written notice violated Rule 3040. It is not credible that they would fail to appreciate that a discussion of a violation of FINRA's rules was important, both as a threat to their plans and as a potential disciplinary issue. The importance of the issue was further emphasized when FINRA followed up the discussion with a telephone conference with Friedman and the consultant at which the issue was discussed both as an obstacle to their desire to form a new broker-dealer and a matter that would be referred to the cause department, and again in written requests for information. Additionally, Respondents were both experienced in the industry. Friedman was a principal and the head of an OSJ, and Schnaier had been in the industry for nine years when they met with the MAP examiners.

[12] Schnaier had no role in the written responses to the MAP department. Tr. 639 – 641, 919 – 921; CX-3; CX-4. Friedman testified that he never discussed the notice issue with Schnaier because he did not think the transactions needed to be disclosed to First Montauk. Tr. 921 – 922, 981 – 983. Schnaier also does not recall any discussions with Friedman in which Friedman said there were problems with their broker-dealer application because of the issue. Tr. 696 – 697. While the Hearing Panel found it credible that Schnaier would have little involvement in the application process for the new broker-dealer, it was not credible that Friedman would have failed to mention that the failure to provide written notice was one of the problems with the application, especially since Friedman was told that the matter was being referred to the cause department for investigation.

To accept Schnaier's contention that he provided written notice and received written approval, the Hearing Panel would have to find that Schnaier neglected to inform Friedman that he had given written notice and received written approval; Schnaier failed to speak up at the MAP interviews when Respondents were informed that their failure to provide written notice might have violated Rule 3040; both Friedman and Respondents' consultant did not inform Schnaier of their responses to FINRA's questions; Schnaier's computer files were destroyed by leaks before he searched them for the notices; written notices and approvals were destroyed by the water damage in Respondents' offices, also before they were searched; Kurinsky acted inconsistently with his standard practice by approving the transactions; and First Montauk failed to maintain copies of the notices and approvals. The Hearing Panel finds that none of these events happened, but it is even more unlikely that all could have occurred. The Hearing Panel finds that Respondents did not submit written notice to First Montauk or receive written approval for either the purchase or sales of Majesco stock.

II. Respondents' Failure to Provide Written Notice to First Montauk Violated NASD Conduct Rules 3040 and 2110

Rule 3040(b) requires an associated person to provide his employer with written notice of private securities transactions before the transactions take place.[13] The rule defines a private securities transaction as "any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities [that] are not registered with the Commission." Oral notice is insufficient to satisfy Rule 3040. *See Joseph Vastano, Jr.*, Exchange Act Rel. No. 50219, 2004 SEC LEXIS 1806, at *14 (Aug. 19, 2004). First Montauk's written supervisory procedures also required all registered

[13] A violation of Conduct Rule 3040 also constitutes a violation of Conduct Rule 2110. *Dep't of Enforcement v. Frankfort*, No. C02040032, 2007 NASD Discip. LEXIS 16, at *39 n.25 (N.A.C. May 24, 2007) (citation omitted).

representatives to notify the firm in writing of any private securities transactions and to receive prior written approval from the firm before selling any securities. Tr. 798; CX-20. There was a similar requirement in the Independent Contractor Affiliate Agreement between Friedman and First Montauk, and in both Respondents' registered representative agreements with the firm. CX-27 – CX-29; Tr. 379 – 380. Respondents violated Rules 3040 and 2110 by failing to give written notice to First Montauk prior to the purchase and sale of the Majesco shares.[14]

The purpose of Conduct Rule 3040 is to ensure that FINRA members can adequately supervise the suitability and due diligence responsibilities of their registered persons. *See Dep't of Enforcement v. Carcaterra*, No. C10000165, 2001 NASD Discip. LEXIS 39, at *8 (N.A.C. Dec. 13, 2001). The Rule also serves to "protect employers against investor claims arising from an associated person's private transactions and to prevent customers from being misled as to the employing firms' sponsorship of the transactions." *Id.* at *8 – *9. "Violation of this rule deprives investors of a member firm's oversight and due diligence, protections they have a right to expect." *Philippe N. Keyes*, Exchange Act Rel. No. 54723, 2006 SEC LEXIS 2631, at *15 (Nov. 8, 2006).

"Participation in any manner" in a private securities transaction under Rule 3040 has been broadly defined, and is "not limited merely to solicitation of an investment." The only case

[14] Even if the Hearing Panel were to accept Schnaier's claim that notices were sent, his testimony would not establish the sufficiency of the notices. The Rule requires that the notice provided to a member firm must describe "in detail" the proposed transaction and the person's proposed role therein, and state whether the associated person has received or may receive selling compensation in connection with the transaction. The phrase "in detail" requires, at a minimum, "the identification of the investor and the amount of money invested." *Dep't of Enforcement v. Ryerson*, No. C9B040033, 2006 NASD Discip. LEXIS 17, at *25 (N.A.C. Aug. 3, 2006). While Schnaier testified at the hearing that there were notices for both the purchase and sale, as well as approvals for each, he testified at his OTR that there was one request for purchase and sales. Tr. 707 – 708; CX-30 at 27. If there was only one notice, it could not have complied with the requirements of Rule 3040. If the notice was provided before the purchase, it could not have provided sufficient information about the sale because Respondents did not know at the time of the sale that they were going to sell it to these specific buyers or what the terms of the eventual sale would be. Additionally, Schnaier testified that he did not remember if the sellers were listed on the notice that he allegedly sent to Kurinsky when Respondents purchased the stock, or if the purchase price was listed when they sold the stock. Tr. 720 – 721.

involving a similar transaction cited by the parties held that the transaction violated the Rule. *Dep't of Enforcement v. Kern*, No. C01970033, 1998 NASD Discip. LEXIS 79 (O.H.O. May 14, 1998). There have been a number of cases involving the sale of securities in which the Representatives had an additional interest, such as ownership of the issuing company.[15] Those cases have held that Rule 3040 covers such transactions, showing that its reach extends beyond a simple sale of securities for a commission.

The history of Rule 3040 also supports its applicability to purchases by a broker and sales of shares owned by a broker. When the predecessor to Rule 3040 was implemented, the Notice to Members announcing the new Rule made it clear that the Rule applies to such transactions:

> The NASD has long been concerned about private securities transactions of persons associated with broker-dealers. These transactions can generally be grouped into two categories:
>
> > 1. Transactions in which an associated person sells securities to public investors on behalf of another party (e.g., as part of a private offering of limited partnership interests, without the participation of the individual's employer firm); or
> >
> > 2. Transactions in securities owned by an associated person.

"New Rule of Fair Practice Relating to Private Securities Transactions, NTM 85-84, 1985 NASD LEXIS 109 (Dec. 18, 1985) (notifying members of the SEC's approval of Article III, Section 40 of the Rules of Fair Practice).

[15] *See, e.g., Jay Frederick Keeton*, Exchange Act Rel. No. 31082, 1992 SEC LEXIS 2002, 50 S.E.C. 1128 (Aug. 24, 1992) (sale of interests organized by the respondent, and in which he was an investor); *Dist. Bus. Conduct Comm. v. Lyon*, No. C07920080, 1994 NASD Discip. LEXIS 54 (N.B.C.C. Feb. 23, 1994) (effected or caused to be effected in a purported private offering, three sales of the preferred stock of … corporation owned and controlled by Lyon, for total proceeds of $52,500); *John P. Goldsworthy*, Exchange Act Rel. No. 45926, 2002 SEC LEXIS 1279 (May 15, 2002) (sale of promissory notes of a company of which respondent was president); *Jim Newcomb*, Exchange Act Rel. No. 44945, 2001 SEC LEXIS 2172 (Oct. 18, 2001) (sale of promissory notes by company owned by respondent and wife).

Respondents violated Rules 3040 and 2110 by failing to provide detailed written notice to their firm of their intention to purchase Majesco, and of their intention to sell the stock.[16]

III. Sanctions

The FINRA Sanction Guidelines for private securities transactions provide that the first step in determining sanctions is to assess the quantitative extent of the transactions, including the dollar amount of sales involved, the number of customers, and the length of time over which the selling away occurred. FINRA Sanction Guidelines at 15 (2007). The Guidelines provide for a fine between $5,000 and $50,000 and a suspension of three to six months when the dollar amount of the sales is $100,000 to $500,000, and six to twelve months when the dollar amount of the sales is $500,000 to $1 million. The Guidelines set forth ten other factors to be considered, in addition to the General Principles and Principal Considerations in Determining Sanctions applicable to all violations.

The dollar amount of the transactions is not as reliable a measure of the severity of the misconduct in this matter as it might be in other cases. *See Dep't of Enforcement v. Calandro*, No. C05050015, 2007 FINRA Discip. LEXIS 17, at *68 – *69 (N.A.C. Dec. 14, 2007), *rev'd on other grounds*, *James W. Browne*, Exchange Act Rel. No. 58916, 2008 SEC LEXIS 3113 (Nov. 7, 2008). Both those who sold the shares to Respondents and those who bought the great majority of the shares were very knowledgeable about Majesco. The family who sold the shares to Respondents owned the company, and their knowledge of the company was almost certainly superior to Respondents'. Trinad, the purchaser of 85% of the shares that Respondents sold, was

[16] Enforcement seeks to characterize the purchase of the Majesco sales as "selling compensation" under Rule 3040, arguing that Respondents were permitted to buy the shares at an artificially low price as compensation for their assistance to Majesco. If Respondents received selling compensation, they could not have engaged in the transaction without receiving written approval from their firm. Rule 3040(c). Similarly, Enforcement argues that Respondents' gain on the transaction should be characterized as selling compensation. Because the Hearing Panel finds that Respondents failed to give written notice at all, it is unnecessary to decide whether Respondents received selling compensation.

Majesco's largest shareholder and had been involved in the investment banking transaction when Majesco did the reverse merger with ConnectivCorp, so it was also likely more knowledgeable than Respondents. Furthermore, Trinad approached Respondents to purchase the shares, and wanted to buy all of Respondents' shares. Joel Gold, one of the other purchasers, was a sophisticated broker who was familiar with Majesco from his own attempt to get the investment banking business, and likely had equal knowledge. As an aggravating factor, however, R.G., one of the purchasers, was a customer of the firm. Neither Trinad Capital nor Joel Gold was a customer of the firm. Tr. 430. This is also an unusual selling away case because it involves the purchase of shares as an investment, and the sale of some of those shares. Respondents were not seeking to earn commissions, and had no stake in Majesco other than as investors. There has been only one similar reported case, the *Kern* case cited above.

The Hearing Panel considered a number of other factors that are identified in the Sanction Guidelines. There is no evidence that anyone was harmed by Respondents' actions. The sellers of the stock to Respondents were not harmed, since they were insiders and presumably made an informed decision to sell the stock to Respondents for a penny a share. All three purchasers bought the shares from Respondents at substantially below the prevailing market price, with the opportunity for a substantial profit. The Department of Enforcement has stated that there is no evidence of harm to the investing public. Department of Enforcement's Pre-Hearing Brief at page 14.

There is no evidence that either the family who sold the shares to Respondents or the three purchasers of the shares were led to believe, or in fact believed, that Respondents were engaging in activity that was sanctioned by First Montauk, or that First Montauk had any role in

the transactions. There is no evidence or allegation that the product sold away has been found to involve a violation of state securities laws or federal, state, or SRO rules.

Although there were general discussions of Majesco as a business opportunity, Respondents did not provide detailed verbal notice to First Montauk of either the purchase or sale of the Majesco shares. This general discussion of the investment banking opportunity provided insufficient notice to First Montauk to constitute a mitigating factor.

There is no evidence that Respondents misled First Montauk or concealed the transactions from First Montauk. The transactions occurred in two discrete blocks, and did not involve a long or continuous course of conduct. Respondents bought their shares in November 2003, and sold them in April and May 2004.

Prior disciplinary history is not an aggravating factor, as neither Respondent has any history of disciplinary problems. CX-17. Respondents have not accepted responsibility for their actions. Friedman accepted some responsibility for his own actions, but has relied on Schnaier's assertions that he followed proper procedures.

Friedman did not intend to violate Rule 3040. His violation was the result of his failure to understand the requirements of Rule 3040. Friedman did not think he needed permission because it was a passive investment. He appears to have confused the provisions of Rules 3030 and 3040. Rule 3030, which requires notice to a representative's firm for outside business activities, exempts passive investments from the reporting requirement. Friedman was not aware that Rules 3030 and 3040 were different rules. Tr. 916 – 917, 960 – 962, 968, 970, 1015.

Schnaier understood that Respondents needed written permission to buy the stock. Tr. 672, 674 – 675. While he claims that he did notify the firm, the Hearing Panel did not find the testimony credible. The Hearing Panel believes that the likely explanation for his failure was

that it also simply did not occur to him to give notice, as the firm would almost certainly have approved the transactions, except the sale to customer R.G. Tr. 356 – 358, 571, 678, 842, 963. Given the nature of the transaction and the fact that Respondents did not seek out the opportunity to buy or sell the shares, the Hearing Panel regarded Schnaier's failure as negligent, not reckless or intentional.

Having considered the nature of the violations and the principal considerations, the Hearing Panel imposes the following sanctions. Respondents are collectively fined $155,000, divided equally between them, resulting in a fine to each of $77,500. There are two components to the fine: an amount to reflect Respondents' financial benefit for the sale to First Montauk customer R.G., plus an additional $50,000. The Hearing Panel believes that it would be punitive, and not remedial, to deprive Respondents of all profits from the transactions. Since it is likely that First Montauk would have approved all the transactions except the sale to R.G., and the sale to an existing customer is the most egregious violation, it is appropriate to require Respondents to disgorge the profits from that transaction. Respondents paid a nominal price for the shares sold to R.G., which the Hearing Panel believes should be disregarded, and sold them to her for $105,000.

In addition, both Respondents should serve suspensions in all capacities. Schnaier's conduct was more culpable, and the Hearing Panel imposes a longer suspension on him. Since Schnaier was the driving force behind the entire Majesco transaction, he should have been more attentive to the requirements of FINRA's rules. Friedman's violation was clearly negligent, and he readily admitted his violation to the MAP examiners. Friedman is suspended for 45 days in all capacities, and Schnaier is suspended for 90 days in all capacities.

IV. Conclusion

For purchasing and selling securities without prior written notice to their firm in violation of Conduct Rules 3040 and 2110, each Respondent is fined $77,500. In addition, Respondent Harry Friedman is suspended for 45 days in all capacities, and Respondent Joseph Schnaier is suspended for 90 days in all capacities.

If this Decision becomes FINRA's final action in this matter, Friedman's suspension will commence on July 6, 2009, and end at the close of business on August 20, 2009, and Schnaier's suspension will commence on July 6, 2009, and end on October 4, 2009. The fines will be due and payable at such time as each Respondent seeks to return to the securities industry. In addition, Respondents, jointly and severally, shall pay costs in the amount of $8,666.63, which represents the cost of the hearing transcripts together with a $750 administrative fee.[17]

HEARING PANEL

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By: Lawrence B. Bernard
Hearing Officer

Copies to: Harry Friedman (*via overnight courier and first-class mail*)
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[17] The Hearing Panel considered and rejected without discussion all other arguments of the parties.