FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF MARKET REGULATION, Complainant, v. JACK LAWRENCE HOWARD (CRD No. 1273894), Respondent.	Disciplinary Proceeding No. 20110263957-01 Hearing Officer—RSH **HEARING PANEL DECISION** June 29, 2015

The Department of Market Regulation failed to prove by a preponderance of the evidence that Respondent violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, and FINRA Rules 2010 and 2020 by trading securities based on material non-public information. Accordingly, the Complaint was dismissed.

Appearances

Edwin Aradi, Esq., Dean Floyd, Esq., and James J. Nixon, Esq. for the Department of Market Regulation.

Stanley S. Arkin, Esq., Lisa C. Solbakken, Esq., Robert Angelillo, Esq., and Deana Davidian, Esq., Arkin Solbakken LLP, and Edward A. Kwalwasser, Proskauer Rose LLP, New York, New York, for Respondent Jack Lawrence Howard.

DECISION

I. PROCEDURAL HISTORY

The Department of Market Regulation initiated this disciplinary proceeding against Jack Lawrence Howard by filing a Complaint with the Office of Hearing Officers on June 20, 2014. The Complaint alleges that Respondent, while Chief Executive Officer ("CEO") and Chairman of Gateway Industries ("Gateway"), purchased Gateway securities on the basis of material nonpublic information and thereby willfully violated Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Rule 10b-5 promulgated thereunder, and FINRA Rules 2020 and 2010.

Respondent answered the Complaint and denied that he traded on the basis of inside information.

The hearing was held in New York City on February 24 and 25, 2015. Market Regulation called Respondent and three other witnesses to testify. Respondent testified in his own defense, but did not call any other witnesses. Twenty of Market Regulation's exhibits, 30 of Respondent's exhibits, and 13 joint exhibits were admitted into evidence.[1]

After a thorough review of the record, the Hearing Panel finds that Market Regulation failed to prove the charges in the Complaint by a preponderance of the evidence. Accordingly, the Hearing Panel dismisses the Complaint.

II. FINDINGS OF FACT

A. Origin of the Proceeding

This disciplinary proceeding arose as a result of an investigation by FINRA's Office of Fraud Detection and Market Intelligence into an increase in the price of the shares of Gateway following the announcement that Gateway would be acquired.[2]

B. Respondent Jack Lawrence Howard

Howard entered the securities industry in 1984 when he became associated with First Affiliated Securities.[3] He was registered with Cowles Sabol from 1989 to 1998.[4] He then became registered with Mutual Securities, where he remains registered as a principal.[5] At all relevant times, Howard held Series 7, Series 24, Series 55, and Series 63 licenses.[6]

Since 1990, Howard has been affiliated with Steel Partners, a private investment firm which, in 2009, was reorganized into a publicly-traded limited partnership. In 2010, the time period relevant to this matter, Howard was president of Steel Partners. In connection with that position, he held directorships and officer positions at companies that were owned or invested in by Steel Partners.[7]

[1] In this decision, "Tr." refers to the transcript of the hearing; "CX" to Market Regulation's exhibits; "RX" to Respondent's exhibits; and "JX" to the parties' joint exhibits.

[2] Tr. 246, 248.

[3] Tr. 55-56.

[4] Tr. 56.

[5] CX-24, at 1-2; Tr. 56 (Cowles Sabol changed its name to Mutual Securities, Inc. in 1998).

[6] CX-24, at 3.

[7] Tr. 59-60, 66.

Howard was a director and shareholder of CoSine Communications ("CoSine") and the CEO, Chairman, and largest shareholder of Gateway, both of which were non-operating shells.[8] He also controlled EMH Howard, LLC ("EMH"), a family-owned limited liability trading company for which he had exclusive trading authority and was managing member.[9] At the time of the hearing, Howard had 28 to 30 years of experience with shell companies.[10]

C. Gateway Industries

In 2009 and the first half of 2010, Gateway had no assets.[11] In 2010, Gateway had no operations or publicly-available financial statements and made no filings with the Securities and Exchange Commission ("SEC").[12] Its stock traded infrequently on the Pink Sheets.[13] The only publicly-available information about Gateway in 2010 was outdated historical financial statements from older SEC filings.[14] Gateway's purpose was to "do a reverse merger at some point in time."[15]

Prior to the trading at issue, which began in October 2010, Howard, personally and through EMH, owned more than 40 percent of Gateway, making him Gateway's largest shareholder. He had acquired most of his stock in 2006 from Steel Partners.[16] He acquired these shares with the long-term goal of one day consummating a transaction such as a reverse merger.[17]

Gateway's second largest shareholder was Knight Equity Markets L.P. ("Knight"), which owned approximately 12 percent of the company. Gateway's third largest shareholder was Walter Carucci, who owned approximately 11 percent of Gateway in his individual capacity and through his affiliate partnership.[18]

During the relevant time period, Gateway shares traded between $0.01 and $0.02 per share.[19]

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[8] Tr. 67-68, 72-73, 79-80.

[9] Tr. 66-67.

[10] Tr. 493-494.

[11] RX-1; Tr. 76-77.

[12] Tr. 81-83; CX-23, at 9.

[13] Tr. 97-98.

[14] Tr. 82-83.

[15] Tr. 492.

[16] Tr. 75, 80; JX-11.

[17] Tr. 492.

[18] JX-11; Tr. 86.

[19] Tr. 225, 439-440.

D. Howard Decides To Increase EMH's Gateway Holdings To 50.1 Percent

In or about mid-2010, Nytis Exploration ("Nytis"), a company whose principals were "very sophisticated and successful," contacted and met with Howard to discuss a potential reverse merger with Gateway.[20] The potential transaction between Gateway and Nytis did not close because Gateway did not have enough shareholders for the type of transaction that Nytis wanted to do.[21] As a result of this process, Howard realized that it would be less costly if Gateway was able to approve a transaction by written consent of a majority of shareholders, as opposed to the more expensive formalities required by a shareholder meeting. Accordingly, soon after the Nytis transaction failed, Howard decided to increase EMH's ownership interest in Gateway from approximately 40.08 percent to 50.1 percent.[22]

Because Gateway traded in the range of $0.01 to $0.02 per share, Howard estimated that acquiring a majority of shares would cost less than $10,000. In contrast, the costs associated with a shareholder meeting—including legal fees, printing, mailing, and soliciting proxies—would be approximately $30,000 to $40,000.[23]

E. Howard's Instructions To Fall

On October 4, 2010, Howard sent an email to one of his traders, Andrea Fall ("Fall"), stating: "Remind me to talk to you about me buying more GWAY to get above 50 percent."[24] Fall responded to Howard: "You need to purchase ~360K [shares] to get to 50.1%."[25] The next day, on October 5, 2010, Howard instructed Fall to purchase a sufficient number of Gateway shares on EMH's behalf "to get [it] to 50.1 percent of GWAY."[26] Howard told Fall to "buy at the market" and that he was willing to pay up to $0.02 per share.[27] Fall testified that she viewed this instruction to be a "good-till-canceled" order that authorized her to buy 360,000 Gateway shares over time until [she] received instructions to stop working on the order.[28]

[20] Tr. 90-92, 448; JX-13, at 26-29, 32; CX-23, at 9; RX-2.

[21] Tr. 92; CX-23, at 10.

[22] Tr. 95, 439-440; CX-23, at 12.

[23] Tr. 225, 439-440.

[24] JX-3; Tr. 95.

[25] JX-3; CX-23, at 20; Tr. 95.

[26] CX-23, at 12, 22; Tr. 439.

[27] Tr. 214, 225, 443.

[28] CX-23, at 21, 22, 24.

F. EMH Acquires Gateway Shares

Through the following series of trades executed between October 5 and November 11, 2010, EMH purchased 275,000 shares of Gateway stock, increasing EMH's ownership to 47.68 percent.

1. On October 5, 2010, Fall, on behalf of EMH, purchased 25,000 Gateway shares at $0.01 for a total of $250, increasing EMH's position to approximately 41.58 percent. After this trade, Fall sent an email to Howard, notifying him that: "EMH bot 25K GWAY [at] 1c." Howard responded that Fall should "keep going tomorrow."[29]

2. On October 13, 2010, Fall purchased 50,000 Gateway shares at $0.01 for a total of $500, increasing EMH's position to approximately 42.80 percent.[30] After this trade, Fall sent an email to Howard, notifying him that she "pried another 50K GWAY @ 1c out of NITE," which "leaves 283K" remaining for EMH to increase its ownership to 50.1 percent.[31]

3. On October 28, 2010, Fall purchased 100,000 Gateway shares at $0.02 for a total of $2,000, increasing EMH's position to approximately 45.24 percent.[32] After this trade, Fall sent an email to Howard, notifying him: "You bot 100K GWAY [at] .02 for EMH."[33]

4. On November 10, 2010, Fall purchased 75,000 Gateway shares at $0.019 for a total of $1,425, increasing EMH's position to approximately 47.07 percent.[34]

5. On November 11, 2010, Fall purchased 25,000 Gateway shares at $0.02 for a total of $500, increasing EMH's position to approximately 47.68 percent.[35] After this trade, Fall sent an email to Howard, notifying him: "I just bot another 25k GWAY from NITE [at] 2c," and that EMH has "83,065 left to buy" to increase its ownership to 50.1 percent.[36]

The only trades at issue in this case are the ones that took place on October 28th, November 10th, and November 11th (the "Subject Trades").[37]

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[29] CX-2; CX-23, at 12, 14, 21; JX-4; Tr. 100.

[30] CX-3; CX-23, at 11-12, 15.

[31] JX-5; CX-23, at 21; Tr. 104-105, 441.

[32] CX-4; CX-23, at 16.

[33] JX-6; CX-23, at 22; Tr. 122.

[34] CX-5; CX-23, at 11-12, 16.

[35] CX-6; CX-23, at 16-17.

[36] JX-8; Tr. 142-143, 291, 443-444.

[37] Complaint ¶ 23.

G. Sillerman's Interest In Raising Capital To Develop His New Technology

Robert F.X. Sillerman ("Sillerman") is in the business of entertainment and technology. In addition to owning "American Idol," in 2007 he sold his company, SFX Entertainment, for $4.4 billion, and in 2011 he sold another company for $5.5 million.[38] While Sillerman has had some spectacularly successful business ventures, he has also been involved in a number of commercial failures.[39]

Although Sillerman may have been well-known within the entertainment business, his was not a household name, and Market Regulation's investigator had never heard of Sillerman prior to her investigation of this case. Howard testified that he had never heard of Sillerman before being contacted by one of Sillerman's investment bankers about a prospective transaction.[40]

In or about August 2010, Sillerman contacted investment banker Lisbeth Barron ("Barron") and her firm, Berenson & Company ("Berenson"), to discuss raising capital to develop "one or two new technologies." Sillerman told Barron that he was interested in a potential transaction whereby he could reverse merge his new venture into a shell company. Sillerman said he would tell Barron more about the technologies after she signed a non-disclosure agreement.[41]

Barron (on behalf of Berenson) and Sillerman entered into a non-disclosure agreement dated August 23, 2010 ("Berenson NDA"). The Berenson NDA provided that "Sillerman is prepared to make available to Berenson certain material, non-public, confidential or proprietary information concerning the Concepts (the information so provided to Berenson . . . the 'Evaluation Material')," and that such material "will be kept confidential" by Barron and Berenson. The agreement further provided that: "Without Mr. Sillerman's prior written consent, the Concepts and Evaluation Material shall not be shown or given to, or otherwise made available to, any other person for any reason whatsoever …." [42]

Barron testified that she understood that the Berenson NDA required her to keep confidential "whatever [Sillerman] was about to tell [her] about [his] two technologies" and "precluded [her] from sharing non-public confidential information." Barron testified that she never breached the Berenson NDA.[43]

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[38] RX-34, at 16-17; Tr. 177, 317, 319-320.

[39] Tr. 301-302, 321; RX-14 (one of Sillerman's companies defaulted on its mortgage and filed for bankruptcy in April 2010); RX-15 (Sillerman's failed attempt to launch a bid to take one of his companies private in 2007); RX-34, at 16 (one of Sillerman's properties was put into receivership).

[40] Tr. 131-33, 280.

[41] Tr. 312, 323-324; JX-1, at 1; RX-36, at 2.

[42] JX-1; Tr. 324-326.

[43] Tr. 326-327, 379-380.

H. Barron Identifies Shell Companies That Meet Sillerman's Requirements

Sillerman instructed Barron to identify publicly-traded companies that he could merge his technology company into and that met his parameters, including his requirement that the company have at least $20 million in cash so he could fund the development of his software.[44]

On or about October 21, 2010, Barron identified to Sillerman five publicly-listed shell companies that met Sillerman's parameters. Each had at least $12 million in cash.[45] Barron's list of shells included, among other companies, CoSine, which held $22.1 million in cash and 47.4 percent of which was owned by Steel Partners.[46] Barron did not identify Gateway as a possible candidate for a potential transaction with Sillerman because it had no cash or assets and, therefore, did not meet the parameters set by Sillerman.[47]

I. Barron First Contacts Howard

Prior to October 27, 2010, Howard had no relationship or communications with Barron or Berenson.[48] On October 27, 2010, Barron called Howard, who was a director of CoSine, to ask if CoSine was available for a potential transaction.[49] Barron told Howard that she had a client who was interested in a potential reverse merger with a publicly-traded shell company with $20 million in cash.[50] Barron told Howard that her client was sophisticated and successful and had done reverse mergers before; however, she did not tell Howard her client's name or anything about his background, experience, technology, or concepts during this call.[51] Nor did Barron tell Howard anything about the type of transaction that her client proposed or its terms and conditions.[52]

Barron testified that she did not give Howard any confidential information during this call. She said the Berenson confidentiality agreement prohibited her from disclosing to Howard any material, non-pubic information about a potential transaction with Sillerman, and she did not breach the agreement.[53]

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[44] Tr. 331-332, 345.

[45] JX-2; Tr. 332-333, 383.

[46] JX-2; Tr. 68, 444.

[47] JX-2; Tr. 383-385.

[48] Tr. 111, 342.

[49] Tr. 67, 105-107, 347, 444-445.

[50] Tr. 106, 138, 347, 349, 446.

[51] Tr. 118, 13, 347-348, 359, 446-447, 448-449.

[52] Tr. 446- 447.

[53] Tr. 372, 379-380.

Howard told Barron that CoSine was not available for a reverse merger because it had substantial tax loss carry-forwards, the value of which would be impaired upon a reverse merger.[54] The next day, October 28, Howard advised Barron that he had another shell that was available, but noted that it had no cash or assets. Howard testified that the shell he had in mind was Gateway.[55]

J. The NDA Between Gateway and Sillerman

Neither Barron nor Howard could recall whether they had telephone conversations between October 28 and November 5. Market Regulation offered into evidence an email from Barron to Howard dated November 5, 2010, to which was attached an unexecuted draft non-disclosure agreement between Gateway and Sillerman (the "Gateway NDA"). Howard did not recall when he first reviewed a draft of the Gateway NDA, and Market Regulation did not prove by a preponderance of the evidence that Howard ever reviewed the draft Barron sent to him on November 5.[56]

On November 11, 2010, Howard, on behalf of Gateway, signed the Gateway NDA.[57] The next day, Barron sent Howard the fully executed Gateway NDA.[58] The Gateway NDA provides that Gateway and Sillerman would begin discussing Sillerman's "two new concepts in the media and technology space (the 'Concepts')," and that Sillerman "is prepared to make available to [Gateway] certain material non-public, confidential or proprietary information concerning the Concepts . . . ." Gateway agreed to use such material "for evaluating a potential transaction," and to destroy or return such materials "unless [Gateway is] invited by Mr. Sillerman to participate in a transaction involving the Concepts . . . ." The Gateway NDA does not contain a "no trade clause" that would prohibit Howard or EMH from trading Gateway securities. [59]

Howard testified that he did not consider the mere fact that the parties executed an NDA to be material.[60] Howard testified that entities with which he is affiliated enter into approximately 100 confidentiality agreements each year in connection with many potential transactions—more than 90 percent of which do not result in any transaction.[61] Moreover, at the time Howard executed the NDA on November 11, 2010: (i) Howard had not yet met Sillerman and had no actual contact with him;[62] (ii) Howard knew nothing about Sillerman's background,

[54] Tr. 68-69, 106, 153, 444.

[55] RX-6; Tr. 445- 446.

[56] JX-7; Tr. 125-130, 350-351, 353.

[57] RX-37; Tr. 448.

[58] JX-9; JX-10; RX-36; Tr. 164.

[59] JX-10.

[60] Tr. 155, 156-157, 160-161, 482-483.

[61] Tr. 93, 217.

[62] JX-9.

experience, or the industry in which he worked;[63] (iii) Howard believed Gateway did not meet Sillerman's requirement of $20 million in cash because it had no cash or assets;[64] (iv) Howard did not know Sillerman's ideas for a potential transaction—much less the structure, price, or any other terms and conditions of any such transaction;[65] (v) the parties had not engaged in any substantive discussions, begun negotiations, exchanged a term sheet, hired counsel, conducted any due diligence, or exchanged any financial information or documents;[66] and (vi) Howard had not notified Gateway's other board member or shareholders of a potential transaction—much less obtained their approval.[67]

After signing the Gateway NDA, Howard did not instruct Fall to stop buying Gateway stock.[68] Fall made EMH's last purchase of Gateway shares on the morning of November 11, shortly before Howard sent his signed NDA to Barron.[69]

K. Events That Took Place Between the NDA and the Final Transaction

Although the Gateway NDA was signed on November 11, a transaction between Gateway and Sillerman was not consummated until February 7, 2011.[70] During those three intervening months, numerous events threatened to scuttle the deal, and it was not certain until near the very last days of negotiations that the transaction would occur.[71]

1. Howard and Sillerman Meet

On November 15, 2010 (four days after EMH's last Gateway purchase), Howard and Sillerman scheduled an initial meeting for November 17, 2010, where Howard would meet Sillerman for the first time and learn about his ideas for a potential transaction.[72] Upon setting up this meeting, Howard instructed Fall to stop trading Gateway shares.[73]

On November 17, 2010, Howard met Barron and Sillerman for the first time. During their meeting, Sillerman gave Howard a "very high level" overview of his business concept.[74]

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[63] Tr. 131-132, 134, 153, 448, 450.

[64] Tr. 216.

[65] Tr. 153, 157, 448, 450.

[66] Tr. 453.

[67] Tr. 166, 206, 209.

[68] RX-8; Tr. 450; CX-23, at 23-24.

[69] CX-6; RX-37.

[70] RX-34; Tr. 175-177.

[71] Tr. 417, 463-465; RX-32.

[72] JX-9; Tr. 155-156, 161, 450-451.

[73] RX-9; Tr. 155-156, 161, 452.

[74] RX-36, at 2; Tr. 155-156, 452- 453.

Sillerman further advised Howard that he needed $20 million to execute any potential transaction, that he had raised $10 million from another source, and that he would need Howard to personally invest $10 million as a prerequisite to any potential transaction.[75] Howard did not have $10 million to invest and was not willing to proceed with any transaction with Sillerman that required him to invest $10 million.[76]

2. Howard Begins Basic Due Diligence

On December 1, 2010, Barron advised Howard for the first time that Sillerman would consider a transaction with Gateway that "does not require [Howard] to put up capital," since he "received a proposal for capital from another source."[77] Howard then began conducting basic due diligence on Sillerman by asking his assistant to run a Google search of Sillerman "so we can learn about him."[78] In response, Howard's assistant sent him articles that reflected a number of Sillerman's commercial failures during the relevant time period.[79]

3. Sillerman Continues Parallel Discussions With Other Shell Companies

Meanwhile, at the time of the Subject Trades, and for months thereafter, Sillerman was engaging in parallel discussions with at least six other shell companies for this same potential technology deal, including at least two with which he entered into confidentiality agreements.[80] Sillerman was also discussing the potential deal with at least one other investment firm, Allen & Company.[81]

As late as December 23, 2010, Sillerman viewed Gateway as one of "dozens of shells" that could be used for his transaction and he was at several points prepared to proceed with a shell other than Gateway.[82] For example, as of December 8, 2010, Sillerman wanted to proceed with a transaction with a shell called Yucaipa Company ("Yucaipa") instead of Gateway.[83] On the morning of December 10, 2010, Sillerman asked that Barron advise him on the status of Yucaipa, stating: "If we don't hear from them today we should put the Gateway deal in

[75] Tr. 164-165, 361, 453.

[76] Tr. 166, 453-454.

[77] RX-12; Tr. 138, 454-455.

[78] RX-13; Tr. 455-456.

[79] RX-14; RX-15; Tr. 466-467.

[80] RX-3; RX-4; RX-22; RX-36, at 2; RX-7; Tr. 329-330, 335-336, 380-382.

[81] Tr. 380-381, 414.

[82] RX-22; RX-16; RX-17; Tr. 381-382, 395-396.

[83] RX-16; Tr. 395-396.

motion."[84] Late that evening, Sillerman advised Barron that, because he had not yet heard from Yucapia, they should "go ahead with Gateway."[85]

4. Sillerman Puts the Potential Gateway Transaction "In Motion"

On December 16, 2010 (more than one month after EMH's last Gateway purchase), Barron sent Howard the first term sheet for a potential transaction between Gateway and Sillerman Investment. This term sheet contemplated a reverse triangular merger whereby Gateway would create a wholly-owned subsidiary that merged into Sillerman Investment.[86] On December 17, 2010, Sillerman began sending Howard due diligence requests "to facilitate the production of information necessary for [him] to properly review [Gateway's] business."[87] Gateway began sending due diligence materials to Sillerman on December 20, 2010.[88]

On December 23, 2010, Howard first apprised Walter Carucci, Gateway's third-largest shareholder, of a potential transaction between Gateway and Sillerman Investment. Specifically, Howard advised Carucci that he was having "meaningful conversations with a high profile" investor interested in a potential transaction with Gateway.[89] Howard advised Carucci of a potential transaction because EMH had stopped purchasing Gateway shares before bringing its holdings above 50 percent and, therefore, Carucci's written consent would help close any potential transaction in a less expensive and more efficient manner than a shareholder meeting.[90]

5. Dispute Between Barron and Sillerman Nearly Ends the Deal

In late December 2010, Barron and Sillerman had a dispute over the terms of Berenson's engagement and Barron's request for a fee of $1-1.5 million for introducing Gateway to Sillerman. On December 23, 2010, Sillerman advised Barron that "[t]here are dozens of these shells available" for a potential transaction. Sillerman further warned that "[t]he SPEA folks have another shell, [and] are willing to fund $1MM simply as an inducement to get us to use their shell," and "Allen and Co wants $300K for the introduction."[91]

On December 30, 2010, Sillerman advised Barron that he would use another shell instead of Gateway if he and Barron could not agree on terms.[92] It was clear to Barron that "the Gateway

[84] RX-17.

[85] RX-18; Tr. 381.

[86] RX-19; Tr. 470.

[87] RX-21, at 2; RX-36, at 2; Tr. 457-459.

[88] RX-36, at 2; CX-23, at 10; Tr. 172.

[89] JX-13, at 5, 12-14, 17.

[90] JX-13, at 26.

[91] RX-22; Tr. 399.

[92] RX-23; Tr. 398, 400, 416.

counterparty was of no consequence to [Sillerman] whatsoever," and that he could "simply mov[e] to another shell . . . as late as December [2010]" because the monetary value was in Sillerman's technology—not in the shell.[93] Sillerman and Berenson did not execute a retainer letter until late December 2010 or early January 2011.[94]

6. Sillerman Sends Howard a Draft Agreement and Gateway Retains Counsel

On January 5, 2011, Sillerman's attorney sent Howard an initial draft "Agreement and Plan of Merger and Reorganization," noting that the draft "has not been reviewed by [Sillerman]" yet. In addition, Sillerman's attorney sent Howard a list of demands, including audited financial statements of Gateway for the years ending December 31, 2007, through December 31, 2009. Gateway did not have audited financial statements for those years, and it was "highly unlikely" that it could obtain audited financial statements in the timeframe Sillerman proposed. Sillerman's attorney also advised Howard that Gateway's "counsel will be required, among other things, to organize the Merger Sub, amend Gateway's Articles of Incorporation to increase the authorized capital stock, prepare board and stockholder resolutions, review the Merger Agreement and complete Parent's Disclosure Schedule."[95]

In late December 2010, Howard retained a law firm to represent Gateway in connection with a potential transaction with Sillerman.[96]

7. Issues Arise During Due Diligence and Negotiations

On January 8, 2011, a "potentially significant issue" arose during Sillerman's due diligence of Gateway that would have "ramifications on the merger timing."[97] On January 10, 2011, Sillerman told Barron: "Obviously we have a problem with Gateway . . . [W]e're going to move on with the Allen and Co shell" instead.[98] Because of these and other problems, as of January 12, 2011, Howard believed there was "a high likelihood" that a deal would not be consummated between Gateway and Sillerman.[99]

On or about January 28, 2011, Sillerman informed Howard that he was unilaterally changing the structure of the transaction from a reverse merger to a recapitalization involving the issuance of shares for $0.03 per share.[100] By email dated January 31, 2011, Howard explained to

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[93] Tr. 417.

[94] RX-36, at 2; Tr. 402.

[95] RX-24; Tr. 460, 463.

[96] Tr. 162.

[97] RX-25.

[98] RX-26.

[99] Tr. 462, 463.

[100] RX-36, at 2; RX-29; Tr. 175, 463.

Barron, "Needed to speak to the other board member and other larger holder about the changed deal …. There is no interest in selling new stock at .03 cents a share. We have always said we believe the shell is worth at least $400-600K as was in the original letter of intent. I am very uncomfortable that we cannot get any due diligence information on Sillerman Investment. I have asked for information over the last couple of months and have received nothing material. Now that we are required to file 10k this is a very large issue."[101] Howard testified that on January 31, 2011, there was a "substantial likelihood that this deal would fall apart."[102]

In early 2011, negotiations ensued with many issues still in dispute, including the structure of the potential transaction, the valuation of Gateway, completion of outstanding due diligence, reimbursement of expenses, whether Howard would comply with Sillerman's demand that Howard indemnify Gateway against any future claims (which Howard refused to do), and filing documents with the SEC.[103] On February 6, 2011, Barron warned Howard that Sillerman "has been running parallel tracks with another shell, which he can close . . . next week" if the parties could not resolve their outstanding issues.[104] On February 6, 2011, Howard was still unsure whether a transaction between Gateway and Sillerman would be consummated.[105]

8. The Recapitalization Agreement

On February 6, 2011, the parties resolved all outstanding issues and finalized the terms of a recapitalization agreement (the "Recapitalization Agreement").[106] On February 7, 2011, the proposed transaction was approved by Gateway's board of directors and a majority of its shareholders, and the Recapitalization Agreement was executed.[107] On February 8, 2011, the Recapitalization Agreement was announced publicly.[108]

L. Howard and EMH Sell Their Shares of the New Entity

On the day the Recapitalization Agreement was announced, the price of Gateway shares jumped from $0.001 to $1.89.[109] Howard began selling his Gateway shares approximately six

[101] RX-29.

[102] Tr. 463-464.

[103] RX-29; RX-30; Tr. 173-175, 465-466.

[104] RX-32.

[105] Tr. 465.

[106] RX-36.

[107] RX-34; Tr. 175-177.

[108] RX-34, at 15-18; Tr. 176, 367.

[109] CX-22, at 5.

months later.[110] Eventually, the total proceeds from the sale of all of Howard's Gateway shares were $1.2 million.[111]

III. CONCLUSIONS OF LAW

In furtherance of Howard's goal of obtaining 50.1 percent of Gateway stock, between October 5, 2010, and November 11, 2010, Howard made five purchases of Gateway shares.[112] Market Regulation alleges that the Subject Trades, made on October 28, 2010, November 10, 2010, and November 11, 2010, violated Exchange Act Section 10(b) and Rule 10b-5, and FINRA Rules 2010 and 2020.

A. Howard Did Not Violate Exchange Act Section 10(b) or Rule 10b-5

To establish a claim under Exchange Act Section 10(b) and Rule 10b-5, Market Regulation must prove by a preponderance of the evidence that Howard (i) purchased or sold securities (ii) on the basis of (iii) material, non-public information.[113] Separately, Market Regulation must establish that Howard acted with scienter, which is defined as "a mental state embracing intent to deceive, manipulate or defraud."[114]

Here, the evidentiary record establishes that the information in Howard's possession at the time of the Subject Trades consisted solely of the following: (i) a call from Barron stating that her client is looking for a publicly-traded shell company with $20 million in cash for a potential reverse merger and inquiring about the availability of CoSine (which Howard advised was not available); (ii) Howard's response that Gateway was available, but had no cash or assets; (iii) Barron's claim that her client was "sophisticated," "successful," and had done reverse mergers in the past; and (iv) Howard's receipt from Barron of an unexecuted draft NDA, which indicated Sillerman is the counterparty.

The Hearing Panel concluded that Market Regulation failed to establish that the information Howard possessed was material.

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[110] Tr. 185.

[111] JX-12; Tr. 89.

[112] October 5, 2010, 25,000 shares at $0.01 for $250; October 13, 2010, 50,000 shares at $0.01 for $500; October 28, 2010, 100,000 shares at $0.02 for $2,000, November 10, 2010, 75,000 shares at $0.019 for $1,425; November 11, 2010, 25,000 shares at $0.02 for $500.

[113] See *United States v. O'Hagan*, 521 U.S. 642, 650-52 (1997); *Simon DeBartolo Group, L.P. v. Richard E. Jacobs Group, Inc.*, 186 F.3d 157, 168-69 (2d Cir. 1999).

[114] *S.E.C. v. Obus*, 693 F.3d 276, 286 (2d Cir. 2012) (applying scienter requirement to insider trading) (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 & n.12 (1976)); *Kalnit v. Eichler*, 264 F.3d 131, 138 (2d Cir. 2001).

1. The Information was Preliminary and Speculative and the Likelihood of a Deal Occurring was Low

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."[115] The Supreme Court has cautioned against "too low a standard of materiality," since this would essentially defeat the purposes of federal disclosure requirements.[116] As the Supreme Court has explained:

> [N]ot only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decision-making.[117]

Courts do not necessarily assess the volume of publicly available information in assessing the materiality of information about a contingent and speculative event that may or may not occur in the future—such as a potential merger or recapitalization. Instead, materiality of information about such events "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."[118] The probability that the event will occur is central to this analysis because reasonable investors "base trading decisions only on information that [is] at least moderately definite and reliable."[119] In evaluating the probability of an event, courts evaluate the "indicia of interest in the transaction at the highest corporate levels," and consider factors such as "board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries."[120] Courts also consider whether the information is "accompanied by specific quantification or otherwise implied certainty."[121]

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[115] *TSC Indus., Inc. v. Northway, Inc*., 426 U.S. 438, 449 (1976); *Azrielli v. Cohen Law Offices*, 21 F.3d 512, 518 (2d Cir. 1994).

[116] See *Basic Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (citing *TSC Indus.* and warning of the "dangers" of a lower materiality threshold).

[117] *TSC Indus.*, 426 U.S. at 448-49 (rejecting a materiality standard defined by what an investor "might" consider important).

[118] *Basic*, 485 U.S. at 238 (quoting *S.E.C. v. Texas Gulf Sulpher Co*., 401 F.2d 833, 849 (2d Cir. 1968)).

[119] *United States v. Heron*, 525 F. Supp. 2d 729, 735 (E.D. Pa. 2007), *rev'd on other grounds*, 323 Fed. App'x 150 (3d Cir. 2009); *Taylor v. First Union Corp.*, 857 F.2d 240, 244-45 (4th Cir. 1988) ("The materiality of information concerning a proposed merger is directly related to the likelihood the merger will be accomplished.").

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

[121] *Elliott Assocs., L.P. v. Covance, Inc.*, 2000 US Dist. Lexis 17099, at *10 (S.D.N.Y. Nov. 28, 2000); *see also, e.g., S.E.C. v. Talbot*, 530 F.3d 1085, 1098 (9th Cir. 2008).

For these reasons, courts routinely caution that preliminary merger discussions should not ordinarily be deemed "material" under securities laws. "The mere fact that a company has received an acquisition overture or that some discussion has occurred will not necessarily be material."[122] To the contrary, information about preliminary, contingent, or speculative negotiations is not material.[123]

In the case *Taylor v. First Union Corp. of S.C.*, the Fourth Circuit found that "merger discussions culminat[ing] in a vague 'agreement' to establish a relationship" were simply not material as a matter of law. There was "no agreement as to the price or structure of the deal," and no "actual negotiations" had taken place. The court found that requiring disclosure of such "preliminary, contingent, and speculative" merger discussions would defeat the very purpose of the materiality requirement. The court emphasized that "[t]hose in business routinely discuss and exchange information on matters which may or may not eventuate in some future agreement," and "[n]ot every such business conversation gives rise to legal obligations." As the court explained:

The materiality of information concerning a proposed merger is directly related to the likelihood the merger will be accomplished; the more tentative the discussions the less useful such information will be to a reasonable investor in reaching a decision. Information of speculative and tentative discussions is of dubious and marginal significance to that decision. To hold otherwise would result in endless and bewildering guesses as to the need for disclosure, operate as a deterrent to the legitimate conduct of corporate operations, and threaten to 'bury the shareholders in an avalanche of trivial information;' the very perils that the limit on disclosure imposed by the materiality requirement serves to avoid. [124]

The Hearing Panel concluded that at the time of the Subject Trades, the information Howard had was clearly "preliminary, contingent and speculative," and the probability that any transaction between Gateway and Sillerman would occur was low.

Barron (who had not yet been formally retained by Sillerman) advised Howard that her client was interested in a potential reverse merger with a shell with $20 million in cash and inquired about the availability of CoSine. Howard responded that CoSine was not available because it had substantial tax loss carry-forwards that would be impaired upon a reverse merger.

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[122] *Glazer v. Formica Corp.*, 964 F.2d 149, 155 (2d Cir. 1992) ("[t]hose in business routinely discuss and exchange information on matters which may or may not eventuate in some future agreement") (citation and quotation marks omitted); see also *S.E.C. v. Wyly*, 33 F. Supp. 3d 290, 300 (S.D.N.Y. 2014) ("something beyond desire to transact is necessary" for a finding of materiality).

[123] See *Taylor*, 857 F.2d at 244-45 ("preliminary, contingent, and speculative" merger discussions with no "actual negotiations" is not material); *Mill Bridge V, Inc. v. Benton*, 496 F. App'x 170, 174 (3d Cir. 2012) ("[n]o reasonable juror" could deem preliminary or tentative expressions of interest material).

[124] *Taylor*, 857 F.2d at 244-45; see also *Hartford Fire Ins. Co. v. Federated Dep't Stores, Inc.*, 723 F. Supp. 976, 984 (S.D.N.Y. 1989); *Carlin Equities Corp. v. Offman*, 2008 US Dist. Lexis 30997, at *10 (S.D.N.Y. Sept. 24, 2008).

Although Howard suggested Gateway the next day, he knew that Gateway did not fall within the parameters set by Sillerman because the company had no cash or assets. Howard did not learn that Gateway was a potential option despite its lack of cash or assets until he met Sillerman for the first time on November 17, 2010. During that meeting, Sillerman told Howard that he would consider Gateway if Howard personally invested $10 million; however, Howard was unwilling to invest that much, making Gateway a less likely option. It was not until December 1, 2010, that Barron first advised Howard that Sillerman would consider Gateway without requiring Howard to invest capital.

There was also no principal-to-principal contact at the time of the Subject Trades; the initial contact between Sillerman and Howard regarding a potential transaction with Gateway was a meeting held on November 17, 2010. In other words, at the time of the Subject Trades, there was no "indicia of interest" in a transaction with Gateway on the part of Sillerman or "actual negotiations" or discussions between principals.

Moreover, at the time of the Subject Trades, Howard had never met Sillerman and knew nothing about his background, experience, the industry in which he worked, or the type of opportunity he presented. Sillerman had not expressed any interest in Gateway to Howard. The two principals had not even met to discuss the potential transaction, much less the structure, price, or any other terms and conditions of any such transaction. The parties had not engaged in any discussions, had no negotiations whatsoever, had not exchanged a term sheet, had not hired counsel, had not conducted any due diligence, and had not exchanged any financial information or documents. Howard had not yet notified Gateway's other Board member or shareholders of a potential transaction.

Although the NDA identified Sillerman as the counterparty, there is no evidence that a reasonable investor would know who Sillerman was or that his identity would carry any more import than any other counterparty. Howard did not begin due diligence on Sillerman until after he learned that Gateway was a viable option on December 1, 2010—almost a month after the Subject Trades. Similarly, Carucci had never heard of Sillerman prior to the transaction at issue. Indeed, Market Regulation's investigator admitted that she had never heard of Sillerman prior to her investigation of this case.

Finally, at the time of the Subject Trades and for months thereafter, Sillerman was engaging in parallel discussions with several other companies for this same potential transaction. Sillerman obtained introductions to these other companies through Barron, Allen & Company, and on his own.

2. The Gateway NDA Was Not Material

The record is unclear as to when Howard reviewed a draft NDA that was sent to him on November 5, 2010. But whether Howard reviewed a draft NDA on November 5, 2010, or the next week (when he signed the NDA), is irrelevant; although the parties executed the NDA, their discussions had not advanced to the point of materiality.

In the case *Mill Bridge V., Inc. v. Benton*, the CEO of the Philadelphia Stock Exchange, Inc. ("PHLX") contacted a director of Archipelago Holdings, Inc. ("ARCA") to inquire into ARCA's interest in a transaction with PHLX. After consulting with ARCA management, the ARCA director responded that ARCA was interested in exploring such a transaction. Thereafter, PHLX's CEO had "introductory discussions" with ARCA representatives, who indicated their desire to gather information about PHLX. The parties executed an NDA so that ARCA could obtain PHLX information to evaluate a potential transaction. The defendant, a PHLX insider, purchased PHLX stock shortly thereafter, but before any due diligence or substantive discussions as to the actual terms of a potential transaction.[125]

The district court determined that discussions preceding the defendant's stock purchase were "far from material." In doing so, the court flatly rejected the plaintiff's argument that execution of an NDA proved negotiations had reached the point of materiality—noting that this argument "evidences a fundamental misunderstanding of corporate negotiation." As the court emphasized, companies considering a merger frequently share sensitive information regarding their respective businesses before actually considering a deal, and will thus enter an NDA before beginning due diligence. "Given that due diligence is simply the exploration of the propriety of doing a business deal, plain reason intimates that a confidentiality agreement entered into in anticipation of such due diligence would not reflect the start of material negotiations." Indeed, the court cautioned that the forced disclosure of such preliminary discussions would defeat the purpose of federal disclosure requirements: "To hold that the tentative and speculative discussions at this juncture were 'material' so as to require disclosure to a potential investor would operate as a deterrent to the legitimate conduct of corporate operations, and threaten to bury the shareholders in an avalanche of trivial information."[126]

The Third Circuit affirmed *Mill Bridge*, explaining that:

> [W]hen [the plaintiff and defendant] agreed to the stock sale, the negotiations between Arca and PHLX were only in their infancy. No reasonable juror could conclude otherwise … The fact that a confidentiality agreement had been signed does not necessarily imply that the negotiations had progressed to the point where they were necessarily material—as the District Court noted, such agreements are "often entered into at the outset of the [merger] process before any material terms are negotiated." Because the merger negotiations were still in their infancy, the fact of the negotiations does not constitute material information that [the defendant] was required to disclose prior to [its] transaction with [the plaintiff].[127]

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[125] *Mill Bridge*, 2010 US Dist. LEXIS 135375, at *5 (E.D. Pa. Dec. 21, 2010), *aff'd*, 496 F. App'x 170 (3d Cir. 2012).

[126] *Id*. at *52 (quoting and discussing *Taylor*, 857 F.2d at 245).

[127] 496 F. App'x 170 (3d Cir. 2012); *See also, e.g., Filing v. Phipps*, 2010 US Dist. LEXIS 100573, at *5-6 (N.D. Ohio Sept. 24, 2010), *aff'd*, 503 F. App'x 297 (6th Cir. 2012).

The same result follows in this case. The mere fact that Barron (not Sillerman) sent Howard a draft NDA is not material. Consistent with this reasoning, Howard's testimony and documentary evidence confirm that Howard did not instruct Fall to stop trading Gateway upon signing the NDA because he did not view the mere fact that the parties executed an NDA to be material. Howard testified that entities with which he is affiliated enter into approximately 100 confidentiality agreements each year in connection with many potential transactions, yet more than 90% of them do not result in any transaction.

Howard's duty to disclose or abstain from trading did not arise upon his execution of the NDA, but upon his subsequent receipt of material, non-public information as contemplated by the NDA.[128] Further, there is no basis to conclude that Howard purposely delayed signing the NDA to justify additional trading activity, as Market Regulation alleged. The record is clear that, even after Howard signed the NDA, he instructed Fall to continue purchasing Gateway shares in accordance with his earlier instructions. This would hardly make sense if he intended to use the unexecuted NDA as a ruse in the manner suggested by Market Regulation. Instead, Howard directed Fall to stop purchasing Gateway only after a meeting date with Sillerman was set.

Having concluded that the information Howard possessed when he purchased Gateway shares was not material, it was not necessary for the Hearing Panel to consider the other elements of the alleged violation.

B. Howard Did Not Violate FINRA Rules 2010 and 2020

FINRA Rule 2010 provides that members "shall observe high standards of commercial honor and just and equitable principles of trade." FINRA Rule 2020 provides that "[n]o member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance."

Because the Hearing Panel found that Howard did not commit insider trading, these rule violations are dismissed.

[128] *Chiarella v. United States*, 445 U.S. 222, 226-30 (1980).

IV. ORDER

The Complaint against Jack Lawrence Howard is dismissed.[129]

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Rochelle S. Hall
Hearing Officer
For the Hearing Panel

[129] The Hearing Panel has considered and rejects without discussion all other arguments of the parties.