16-1739-cv

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

TALMAN HARRIS,

Appellant/Petitioner,

v.

U.S. SECURITIES & EXCHANGE COMMISSION,

Appellee/Respondent.

Petition for Review of the Opinion of the
U.S. Securities & Exchange Commission

PAGE PROOF REPLY BRIEF OF PETITIONER

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Petitioner, Talman Harris ("Harris" or the "Petitioner"), hereby submits this reply brief in further support of his petition for review of the decision of the United States Securities and Exchange Commission ("SEC"), and states the following:

I. INTRODUCTION

The SEC, in its brief filed on January 4, 2017 ("SEC Brief") in opposition to Harris' initial brief filed on October 7, 2016 ("Initial Brief"), misapprehends relevant case law and mischaracterizes Harris' arguments.

Fundamentally, Harris did not violate Section 10(b) of the Securities Exchange Act (the "Exchange Act"), Rule 10b-5 thereunder, or FINRA Rules 2020 and 2010 (collectively, the "anti-fraud provisions") for two reasons. First, Harris had no duty to disclose the payment First Merger received from DEER for advisory services (the "DEER Payment"). The SEC expressly determined that the payment was not tied to the sale of DEER securities, or any other prior dealings. Second, even if Harris did have a duty to disclose, he was not reckless in failing to do so. There is no precedent requiring a broker to disclose a fact unrelated to the transaction at issue. In addition, there was no evidence to support the conclusion that a reasonably prudent securities professional would have found it necessary to disclose the DEER Payment.

Assuming arguendo that Harris did violate the anti-fraud provisions, the sanction imposed – a lifetime bar from the industry – is excessive, oppressive, punitive, and not remedial, particularly due to the lack of precedent requiring a disclosure here. As the transactions at issue were not related to the Deer Payment, it was not unreasonable to conclude that the DEER Payment did not have to be disclosed. Furthermore, the SEC's sanction was arbitrary and capricious for the reasons described in the Initial Brief, and particularly in light of the fact that the SEC failed to consider the lack of customer harm and the extent of Harris' individual involvement in any purported harm.

II. ARGUMENT

A. Harris Did Not Violate the Anti-Fraud Provisions

1. Harris Had No Duty to Disclose the Deer Payment

The SEC conflates the materiality requirement of liability under Section 10(b) with the independent condition that there first be an independent duty to speak. Whereas a broker acting with scienter is always liable for a material misrepresentation made in connection with the purchase or sale of a security, a broker can only be found liable for a material *omission* if he first had a duty to speak. See, e.g., Basic Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988) (stating that "[s]ilence, absent a duty to disclose, is not misleading under Rule 10b-5"); Overton v. Todman & Co., CPAs, P.C., 478 F.3d 479, 483 (2d Cir. 2007) ("A fundamental principle of securities law is that before an individual becomes liable for his silence, he must have an underlying duty to speak."). It would be antithetical to hold that a duty to disclose a material fact arises simply because the fact is material – the actor must have had a duty to disclose in the first place.

The SEC admits that there is no general fiduciary duty – and, therefore, no general duty to disclose – between a broker and his clients. (SEC Brief at 22). Instead, under New York law, a duty to disclose material facts exists between a broker and a customer only with respect to "*those matters that have been entrusted to the broker*." U.S. v. Wolfson, 642 F.3d 293, 295 (2d Cir. 2011) (emphasis added). However, the SEC unreasonably stretches a broker's obligations to his clients when it pronounces that any "material information regarding the recommendation to purchase a security is such a matter [that has been entrusted to a broker]." (SEC Brief at 22).

Despite the SEC's contentions, a broker making recommendations to his customers does not automatically assume a position of trust and confidence with respect to the recommendation. Rather, the broker is only responsible for "the matters entrusted to the broker," otherwise known as the "*narrow task of consummating the transaction requested*." Press v. Chemical Investment Services Corp., 166 F.3d 529, 536 (2d Cir. 1999) (emphasis added); see In re Refco Securities Litigation, 759 F. Supp. 2d 301, 323 (S.D.N.Y. 2010) ("[W]here a broker does not have discretionary trading authority over an account, the broker's only duty is the proper execution of transactions upon explicit customer instructions"). Thus, between a broker and his client, a duty to disclose exists where there is a transactional nexus, i.e., a nexus between the transaction and the issue to be disclosed.

Although the SEC acknowledges that the cases cited by Harris include a transactional nexus, it argues that none of those cases *required* it. (SEC Brief at 25). However, the SEC failed to identify a *single* case in which a broker was found liable for failing to disclose a material fact unrelated to the transaction at issue. Instead, the SEC cites to the following cases, all of which had a transactional nexus for the reasons described below:

- U.S. v. Santoro, 302 F.3d 76 (2d Cir. 2002), U.S. v. Szur, 289 F.3d 200 (2d Cir. 2002), In re Derek L. DuBois, Exchange Act Release No. 48332, 2003 WL 21946858 (Aug. 13, 2003), and In re Richard H. Morrow, Exchange Act Release No. 43092, 1998 WL 556560 (Sept. 2, 1998), all of which involved extraordinary commissions or other compensation directly related to the sale of the recommended securities;
- U.S. v. Nouri, 711 F.3d 129 (2d Cir. 2013), which involved bribes paid by the issuer of the recommended security directly tied to the transactions;

- U.S. v. Laurienti, 731 F.3d 967 (9th Cir. 2013), Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1970), and In re Richmark Capital Corp., Exchange Act Release No. 48758, 2003 WL 22570712 (Nov. 7, 2003), all of which involved brokers who owned or otherwise maintained a position in the securities they were selling and thus were directly affected by the transactions; and
- Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969), which involved several affirmative misrepresentations and a failure to disclose adverse information about the recommended company's financial difficulties and thus plainly impacted the company's valuation and directly affected the transactions.

Indeed, even In re Kevin D. Kunz, Exchange Act Release No. 45290, 2002 WL 54819) (Jan. 16, 2002), on which the SEC so heavily focuses, involved a transactional nexus that is not present here: the broker-dealer in Kunz was specifically opened with the preexisting intention of "act[ing] as selling agent or underwriter for the private placement offerings." 2002 WL 54819, at *2.

The SEC argues that "[u]p-front payments that are . . . *tied to the recommendation* of an issuer's security are no less material to customers than payments made only after and in consequence of the completed transaction," (SEC

Brief at 24 (emphasis added)). In fact, the SEC is correct in this regard. However, the timing of payments "tied to the recommendation of an issuer's security" is wholly irrelevant. The key, instead, is that there be proof that the payments are *tied to* the recommendation.

There were no such findings here. In fact, the SEC expressly determined that the Deer Payment was not a "transaction-based payment." (SEC Decision at 9 n. 32).[1] As a result, the SEC's decision that Harris had a duty to disclose this payment was therefore not in accordance with the law and should be reversed.[2]

2. Harris Did Not Have the Requisite Scienter

The SEC argues that Harris was reckless because the duty to disclose the DEER Payment was not ambiguous but, rather, stems from "long-standing"

[1] While the SEC summarily concluded that it should have been disclosed to customers because "it appears that the payment was a form of *quid pro quo* for later, general recommendations of DEER securities," (SEC Decision at 9 n. 32), this speculation by the SEC is a mere guess that is not supported in the record and thus cannot constitute the basis of its decision.

[2] The SEC's conclusions of law should be reversed if they are "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law" or "without justification in fact." See Mathis v. SEC, 671 F.3d 210, 215 (2d Cir. 2012); Markowski v. SEC, 34 F.3d 99, 105 (2d Cir. 1994). The SEC's conclusions of fact, on the other hand, should be reversed if they are not supported by substantial evidence. See Mathis, 671 F.3d at 216. As explained in the Initial Brief, Harris is not contesting the factual findings underlying the SEC's conclusions. Rather, Harris is contesting the conclusions that the SEC drew in finding that Harris committed securities fraud.

case law. (SEC Brief at 27). However, as noted in Section II.A.1, *supra*, the cited cases all involve a transactional nexus between the purported conflict and the transaction at issue. For the reasons set forth above and in the Initial Brief, no such transactional nexus exists here.

The SEC also argues that whether other securities professional knew about the payment and did not disclose it is not relevant to Harris' purported recklessness. But, recklessness contains both a subjective *and* an objective component, and a finding of recklessness requires an examination of "what a reasonably prudent securities professional under the circumstances would do." See Gebhart v. SEC, 255 Fed. App'x 254, 255-56 (9th Cir. 2007).

With no evidence, the SEC cursorily found that Harris was reckless in not proactively divulging the DEER Payment to customers. However, the only evidence available – that (1) there has never been a case in which a broker was found to have violated Section 10(b) for omitting a fact unrelated to the transaction at issue, and (2) several other securities professionals knew about the DEER Payment and did not disclose it[3] – weighs against a finding that a reasonably

[3] Indeed, Maureen Gearty, who the Hearing Panel determined was an overall "credible witness," stated that she did not know that the DEER Payment needed to be disclosed, (R. 1066:3-7), and at least three other securities professionals – including a securities lawyer and a Chief Compliance Officer – knew about the DEER Payment and did not suggest that it should be disclosed. Accordingly, this was not a "highly unreasonable" omission such that Harris was reckless in

prudent securities professional would have found it "highly unreasonable" and "an extreme departure from the standards of ordinary care" to disclose the DEER Payment. Accordingly, Harris was not reckless, and he therefore lacks the requisite scienter to be found liable here.

B. Even if Harris Violated the Anti-Fraud Provisions, the Sanctions Imposed Were Excessive, Oppressive, and Punitive, Not Remedial.

This Court must review the SEC's legal conclusions, and overturn its sanction determinations, if it finds that they were "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A). In making sanctions determinations, the SEC is required to provide a "meaningful statement of the reasons" for the sanction, "explain its reasoning," and properly weigh the respondent's violations against any mitigating factors. See McCarthy v. SEC, 406 F.3d 179, 188 (2d Cir. 2005); Saad v. SEC, 718 F.3d 904, 912-13 (D.C. Cir. 2013).

Importantly, in upholding the sanctions against Harris, the SEC claimed that a lack of customer harm is not mitigating. (SEC Decision at 16-17). In so doing, the SEC ignored FINRA's own Principal Considerations in Determining Sanctions, which mandates that FINRA at least consider whether the

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failing to disclose it. See Novak v. Kasaks, 216 F.3d 300, 308 (2d Cir. 2000) (defining recklessness as "conduct which is 'highly unreasonable' and which represents 'an extreme departure from the standards of ordinary care'").

respondent's conduct "directly or indirectly" caused injury to other parties. See FINRA Principal Consideration No. 11. The SEC made no findings as to how many customers were affected specifically by Harris as opposed to Scholander. There was no evidence of customer harm. By not making proper factual findings as to the extent of Harris' involvement in the alleged violations and the extent of any purported customer harm, the imposed sanctions – and, particularly, the decision to bar Harris for life – are arbitrary and capricious, and this Court must overturn them.

III. CONCLUSION

Harris had no duty to disclose the DEER Payment, and even if he did, he lacked the requisite scienter. There does not appear to be a *single* case in which a broker was found liable for failing to disclose a material fact unrelated to the transaction at issue, and it was not unreasonable for Harris to think that he was not required to disclose the DEER Payment. Nevertheless, even if Harris had committed a violation by failing to disclose the Deer Payment, the sanction imposed upon Harris is excessive, oppressive, and unwarranted, and not remedial. Harris should not be barred from practicing in the industry forever.

Accordingly, for any or all of the foregoing reasons, and for those reasons set forth in the Initial Brief, the SEC's decisions should be reversed.

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1. This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because this brief contains 2,138 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii).

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/s/ Amy E. Sparrow
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CERTIFICATE OF SERVICE

I, Amy E. Sparrow, hereby certify that on January 17, 2017, I caused a true and correct copy of the foregoing Reply Brief of Petitioner to be filed via ECF and via United Parcel Service, overnight delivery, with the United States Court of Appeals for the Second Circuit, and to be sent via email and United Parcel Service, overnight delivery, to the following:

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