BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of Department of Enforcement, Complainant, vs. William Scholander New York, NY, and Talman Harris Garden City, NY, Respondents.	DECISION Complaint No. 2009019108901 Dated: December 29, 2014

Respondents fraudulently omitted material facts when soliciting purchases of securities and engaged in outside business activities without providing their employer with prompt written notice. Held, findings and sanctions affirmed.

Appearances

For the Complainant: Jeffrey P. Bloom, Esq., Leo F. Orenstein, Esq., Michael J. Dixon, Esq., Department of Enforcement, Financial Industry Regulatory Authority

For Respondents: Jon-Jorge Aras, Esq., Samuel Halterman, Esq.

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Decision

From February 2010 through November 2010, William Scholander ("Scholander") and Talman Harris ("Harris") (together, "respondents") sold $961,825 of Deer Consumer Products, Inc. ("DEER") securities to customers. When doing so, respondents did not disclose that they recently received from DEER a $350,000 fee for advisory services, which they spent in furtherance of a plan to acquire a broker-dealer. In addition, neither Scholander nor Harris disclosed to their firm the activities in which they engaged that led to the $350,000 fee or that they received the fee. We are asked to decide: (1) whether respondents' failure to disclose the $350,000 fee and their business relationship with DEER was a fraudulent omission of material fact, in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Rule 10b-5 thereunder, and FINRA Rules 2020 and 2010; (2) whether respondents engaged in outside business activities without giving prompt written notice to their employing firm, in violation of NASD Rule 3030 and FINRA Rule 2010; and (3) the appropriate sanctions for any such violations.[1] Because we find that respondents omitted material facts in connection with their sales of DEER, did so with scienter, and failed to give prompt written notice to their firm of their outside business activities for DEER, we affirm the Hearing Panel's findings that respondents committed fraud and engaged in outside business activities violations. We also affirm the bars imposed by the Hearing Panel for respondents' fraudulent omissions.

I. Background

Since 1997, Scholander has associated with 13 firms and registered with 11 firms. From March 2009 to February 2010, Scholander was registered with Seaboard Securities, Inc. ("Seaboard Securities"), as a general securities representative. From February 2010 to March 2011, Scholander was registered with First Merger Capital, Inc. ("First Merger"), as a general securities representative and (beginning in March 2010) an investment banking limited representative.

Since 1998, Harris has associated or registered with 16 member firms. From May 2009 to February 2010, Harris was registered with Seaboard Securities as a general securities representative. From February 2010 to March 2011, Harris was registered with First Merger as a general securities representative, an investment banking limited representative, and, during the last month of that association, a general securities principal.

Respondents first met each other in the late 1990s when they worked for the same firm. Since 2002, Scholander and Harris have operated as partners and have generally worked at the same firms. Since 2007, respondents have co-owned branch offices, except during their tenure at First Merger, when they attempted to acquire the firm with two other persons. Harris and Scholander are currently registered with another member firm and jointly own a branch office.

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[1] The conduct rules that apply in this case are those that existed at the time of the conduct at issue.

II. Procedural History

On January 31, 2012, FINRA's Department of Enforcement ("Enforcement") filed a three-cause complaint against Scholander and Harris. Cause one alleged that respondents made fraudulent sales of securities issued by DEER, in willful violation of Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, and FINRA Rules 2020 and 2010. The crux of Enforcement's allegations was that respondents sold DEER securities to customers while fraudulently omitting to disclose that respondents had a consulting agreement with DEER and received $350,000 from DEER pursuant to that agreement. Cause one also alleged that respondents failed to disclose the same information to other First Merger representatives who sold DEER securities, causing those representatives not to disclose the information to their customers. Cause two alleged that respondents engaged in outside business activities in violation of NASD Rule 3030 and FINRA Rule 2010 by entering into a financial consulting agreement with DEER while registered with, and without disclosing that agreement in writing or otherwise to, Seaboard Securities. Cause three alleged that respondents caused First Merger's books and records to be false and misleading in not reflecting actual commission payments to individual representatives, in violation of NASD Rule 3110 and FINRA Rule 2010. Respondents filed an answer denying the allegations and raising several affirmative defenses.

On August 16, 2013, the Hearing Panel issued a decision finding that respondents engaged in fraud and in outside business activities without providing prompt written notice to their firm. The Hearing Panel barred respondents for their fraud violations. For respondents' outside business activities violations, the Hearing Panel indicated that a $10,000 fine imposed on each respondent would have been appropriate but did not impose those fines in light of the bars imposed. Finally, the Hearing Panel dismissed the allegations of books and records violations.[2] Respondents filed this appeal.[3]

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[2] Enforcement has not appealed the Hearing Panel's dismissal of cause three. We exercise our discretion not to address the allegations in cause three.

[3] On July 23, 2014, while this appeal was pending and after the parties filed appellate briefs and made oral arguments, FINRA's Office of General Counsel ("OGC") informed the parties that the Office of Hearing Officers ("OHO") transmitted to OGC five exhibits that were admitted into evidence but which were inadvertently omitted from both the index to the record and the certified record that OHO transmitted to OGC on October 3, 2013. Subsequently, respondents moved to dismiss the proceeding on the grounds that the "entire *de novo* nature of the NAC hearing has been compromised" by the omission of the five exhibits. Respondents' motion is denied. Respondents were given early notice, via the index, that the exhibits were not included in the record, but they did not raise any objection for more than eight months. Moreover, respondents have not been prejudiced. Respondents had a full opportunity to rely on the exhibits in making their written and oral arguments and could have sought leave to file additional briefing if they felt that additional briefing was necessary. In addition, the NAC Subcommittee that was empaneled in this proceeding had the opportunity to review and consider the five exhibits when it was preparing its recommended decision.

III. Facts

This case centers on the assertions that Scholander and Harris, from February through November 2010, solicited purchases of DEER securities, without disclosing that they recently received a $350,000 payment from DEER or that they had a business relationship with DEER. In support of such assertions, Enforcement argues that respondents were among the primary beneficiaries of the $350,000 fee and used it towards their attempt to acquire a broker-dealer with two other persons, Ronen Zakai ("Zakai") and Maureen Gearty ("Gearty"). Respondents, on the other hand, assert that the $350,000 payment was not for their personal benefit but, rather, for Gearty's sole benefit. To resolve these critical factual disputes, and examine respondents' economic self-interests raised by their dealings with DEER, requires that we explore the entire context of the $350,000 fee, including respondents' longstanding business relationship with DEER's promoters, respondents' prior and ongoing business relationship with DEER, the steps respondents took towards acquiring a broker-dealer, the details of the acquisition plan, the activities in which respondents engaged towards earning the $350,000, and how the $350,000 was used in furtherance of respondents' plan to acquire a broker-dealer.

A. Respondents' Business Ties to Person A and Person B and Their Business Relationship with DEER

As this decision will show, the $350,000 fee from DEER was the fruit of respondents' longstanding business dealings with Person A and Person B, Person A's friend and attorney. Person A co-founded, and was president of, Corporation P, a "middle market advisory firm on Wall Street specialized in executing China related transactions." Person A's firm introduces Chinese companies to the U.S. markets.

As of the relevant period—fall 2009 through November 2010—respondents had a close business relationship with Person A that dated back to 2002. Early in that relationship, respondents worked for a broker-dealer that was largely owned by Corporation P. Later, and for years thereafter, respondents subleased office space within Corporation P's office suite during respondents' associations with other broker-dealers. Over the years, respondents offered and sold the stock of several companies with which Person A and Person B had relationships. Person A and Person B, the issuing companies' attorney, cultivated this business by introducing the issuing companies to Scholander and Harris, bringing representatives of the issuers to respondents' offices, and arranging for respondents and their colleagues to visit the issuers in China.

Among the securities that respondents sold as a result of this relationship were ones issued by DEER.[4] Prior to the relevant period, Person A accompanied DEER representatives to

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[4] DEER is a Nevada corporation that has its principal offices in China. In its Form 10-K for the fiscal year ending December 31, 2009, DEER stated that "[w]e are a leading Chinese designer, manufacturer and seller of quality small home and kitchen electric appliances." DEER's common stock began listing on the NASDAQ stock market on July 17, 2009, and upgraded its listing to the NASDAQ Global Market on October 22, 2009.

Scholander's offices, and Person B brought DEER to Scholander to handle a private placement. Then, respondents sold two parts of a DEER private placement, the first part in 2008 before joining Seaboard Securities, and the second part when registered with Seaboard Securities.

B. Person A Introduces Respondents to Ronen Zakai, Who Invites Respondents to Acquire a Broker-Dealer with Him and Maureen Gearty

In fall 2009, Person A introduced Scholander and Harris to Zakai. Zakai was, or recently had been, a broker at GunnAllen Financial ("GunnAllen") and, in that capacity, traveled to China with Person A earlier in 2009. Like respondents, Zakai also had a connection to DEER. DEER made a presentation at GunnAllen, and Zakai later recommended DEER to his GunnAllen customers.

While at GunnAllen, Zakai worked with Gearty, an operations manager and office manager. As a GunnAllen operations manager, Gearty handled "all the basic operations of a firm," including maintaining client records, filling in on the order entry desk, and handling all paperwork for any "IPOs or anything we did."

Around the time when Zakai met respondents, Zakai and Gearty had already been considering trying to acquire a broker-dealer.[5] In September 2009, Zakai used a business broker to locate an acquisition target named Brentworth and Company, Inc. ("Brentworth"), which was owned by Mark Simonetti ("Simonetti"). Zakai also retained a firm named ACI to assist with filing an application to change Brentworth's ownership with FINRA.

At some point, Person B proposed that Zakai, Gearty, and respondents—who were looking to leave Seaboard Securities over certain disputes—open their own firm together. After searching for an acquisition target or finding Brentworth, Zakai began discussing this possibility with Scholander and Harris.[6] Zakai testified, at an on-the-record interview, that he informed Scholander and Harris that acquiring a broker-dealer would require approximately $300,000, that they each would have to contribute $100,000, and that his plan was to "give [Gearty] a little . . . percentage" of the broker-dealer, but that she would not be required to provide any financing.

Gearty's testimony about what happened next was as follows. In a September 2009 meeting in Corporation P's conference room, Zakai introduced Gearty to respondents. Zakai and respondents had already decided "to open a firm together."[7] At that meeting, Zakai, Scholander,

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[5] Gearty testified that she and Zakai discussed the idea, and that Zakai "took that ball and acted on it."

[6] According to Zakai, his initial discussions with Scholander and Harris took place in September 2009. Scholander suggested that the discussions commenced earlier in the year, around May or June. The difference in testimony is not material.

[7] In contrast, Scholander implied in his testimony that he met Gearty before discussing with Zakai the prospect of acquiring a broker-dealer. The difference between Scholander's testimony and Gearty's testimony is not material. Scholander also claimed that he and Harris did

[Footnote continued on next page]

Harris, and Gearty discussed the acquisition plan with Person A, whom Gearty characterized as "the mastermind behind this whole thing," and Person A interviewed Gearty. Person A informed them that to facilitate the acquisition, "the guys had to open [limited liability companies]" but that Gearty did not have to "because [she] was only going to be a small owner" and "an operations person."[8]

Gearty further testified that towards the end of September 2009, or beginning of October 2009, Zakai, Scholander, Harris, and Gearty visited Simonetti. By that time, Zakai, Scholander, Harris, and Simonetti had already agreed to the acquisition price for Brentworth, and everyone at the meeting except Gearty discussed the purchase of Brentworth, the price, the plans, and "what they were actually purchasing."

Consistent with their acquisition plan, Zakai, Scholander, and Harris each formed a business entity. In fall 2009, Zakai formed RRZ Management, Inc. ("RRZ Management"), which was owned by Zakai's wife and his brother-in-law.[9] Scholander and Harris each formed companies as well, Infinite Dragon, LLC ("Infinite Dragon"), and First Auriga, LLC ("First Auriga"), respectively. Gearty testified that she understood "all three entities were going to attempt to purchase" a broker-dealer.

According to various documents, RRZ Management entered into an agreement on October 13, 2009, to purchase Brentworth for $85,000. The purchase agreement included the condition that a branch office be opened. Brentworth subsequently changed its named to First Merger.[10]

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not agree to partner with Zakai and Gearty until January 2010. As explained below, however, the preponderance of the evidence shows that the purchasing group agreed in fall 2009 to acquire Brentworth.

8 In contrast to Gearty's testimony, Harris testified that Person C, a lawyer who worked with ACI, advised of the need to open business entities to facilitate the acquisition, not Person A. The different testimony on this issue is immaterial. Regardless of who advised of the need to form business entities, they key point is that respondents were informed of the plan to do so.

9 Although Zakai formed RRZ Management, Person C advised Zakai not to be an owner because he had "one or two marks on [his] license" that might affect First Merger's application to change ownership. Around that time, Zakai had recently entered into a Letter of Acceptance, Waiver, and Consent in which he consented to a $5,000 fine and a 30-day suspension in connection with allegations that he borrowed money from a customer without providing notice to his firm.

10 This decision refers to the broker-dealer as "Brentworth" or "First Merger" as appropriate.

In late October 2009 or the beginning of November 2009, Gearty was given a 2% ownership interest in RRZ Management. On October 23, 2009, Gearty left GunnAllen and immediately began working in respondents' Seaboard Securities offices or within the same office suite, in furtherance of the acquisition plan. Gearty looked for a clearing firm, communicated with Simonetti, purchased desks, and helped ACI with any paperwork it needed; spoke with Scholander and Harris "[e]very single day" about her progress towards opening the branch office; and saw Person A "every day" and discussed her work with him. Scholander similarly testified that he saw Gearty and Zakai on "pretty much a daily basis."

C. Scholander and Gearty Travel to China to Visit DEER and Receive a Fee

In early November 2009, Scholander and Gearty traveled to China to visit DEER. Gearty's testimony about the trip was as follows. In late October 2009, Scholander called her into a meeting with Person A. Person A and Scholander informed her that, the following week, she and Scholander would travel to China to visit DEER. Gearty had never been to China or visited an issuer. Person A selected her flights and hotel, and Scholander immediately paid for the airline tickets using his personal credit card. Person A also obtained her visa. Asked whether she was told the purpose of the trip, Gearty testified that Scholander and Person A said it was "[j]ust to go see DEER," and she understood that "I would be the face of First Merger" so "they wouldn't forget that they saw me." Scholander, Harris, and Zakai also indicated to Gearty that the trip was going to result in a fee. Gearty did not understand why a fee would result, just that "[w]e were . . . going [to China] to . . . get a fee." At some point before, during, or after the trip, Gearty was told that the fee was going to be $250,000.

According to Gearty's hearing testimony, she and Scholander, after arriving in China, went to DEER's offices for "two hours tops" and that, when meeting with DEER, "[w]e had to . . . tell them we were from" First Merger/Brentworth. When she and Scholander were introduced to DEER's CEO and some DEER representatives, "one guy from [Person A's] office" was present, and they visited a room where they "looked at all the coffee makers and waffle makers." No one asked Gearty for any advice, she was never separated from Scholander, and she had no separate meetings with any DEER representatives. After visiting DEER's offices, she and Scholander were taken to a mall to see a DEER display, she had no further conversations with DEER while in China, and she did not know if Scholander attended any other meetings at DEER. Gearty gave additional details in prior testimony at a continuing membership interview. When asked whether she performed any "consulting services" that "resulted in the receipt of" a fee, Gearty testified, "I went to China, . . . and actually looked at all their [kitchen appliance] products, and they asked me which products did I like, which didn't I like," despite that "I did not have any product expertise."

Scholander, during an on-the-record interview, provided a similar version of his activities during the China trip that contained significant admissions. Scholander admitted that, during the trip, he performed some consulting work for an "advisory fee":

> [Gearty] and I . . . went to China to go visit [DEER] before the advisory fee. We actually sat down with them there and discussed . . . how

> they're going to grow. They were discussing Bank of Montreal as well and asking about them. I said, "It's a very prestigious firm, and I'm glad that you picked going with them as well."[11]

Scholander elaborated, "Well, we went to China. We were talking about their products, and I was giving my advice to put them in different stores and what I felt firsthand how I would sell their product." Scholander also explained what, outside of the advice provided during the China trip, was done to receive the "advisory fee":

> Well, basically, we had a conference call with [Person B], "we" meaning . . . myself, and Talman Harris, Maureen Gearty . . . giving our opinions in the company [DEER] and what they can do to improve and appeal to the investors. I believe that [sic] what the gist of it was. I spoke a couple of times on that. That's about it . . . . It was a couple of calls. I'm not sure of the time frame.[12]

Scholander admitted that he was involved in providing services to DEER. Gearty and Scholander stayed in China two nights and then flew home to New York. Gearty testified that, when they returned, she and Scholander discussed the trip with Harris and Zakai and how it "was like a joke. You know, we went there and it was the easiest $250,000 ever."

D. Events Around and After the China Trip

Around and after the time of the China trip, the members of the purchasing group took additional steps in furtherance of their plan to acquire First Merger. On November 9, 2009, Gearty registered with First Merger. In addition, Scholander paid a substantial amount of the purchase price. Specifically, by check dated November 2, 2009, and pursuant to Zakai's instructions, Infinite Dragon, the company formed by Scholander, deposited $65,000 into a law firm escrow account. On November 20, 2009, that $65,000 was released from escrow to pay Simonetti.[13] Scholander admitted that the $65,000 was for the purposes of acquiring First Merger.

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[11] The record suggests that Scholander's comment about "going with [Bank of Montreal]" related to a secondary offering that DEER was contemplating.

[12] Scholander subsequently gave a completely different version of his China trip in both a written affidavit and his hearing testimony, in which he claimed that he and Harris had nothing to do with the fee and that it was only Gearty's money. Harris likewise claimed at the hearing that the fee was solely Gearty's.

[13] Scholander testified that the $65,000 was released from escrow without his approval. But Scholander provided no evidence, such as the terms of the escrow or purchase agreements, showing that the release of funds was improper. Indeed, although Scholander was asked about the $65,000 payment during a continuing membership interview, he never indicated that the funds were released from escrow inappropriately. Further undermining his claim of impropriety,

[Footnote continued on next page]

At the same time, efforts were made to obtain the fee from DEER, which Gearty testified "was completely understood" would be used to "open" the broker-dealer. According to Gearty, within two weeks after the China trip, Zakai informed her that the fee was increasing from $250,000 to $350,000. Zakai gave no reason for the increase, and Gearty, Scholander, and Harris "high-fived each other on it." Gearty testified at the hearing that she never provided any services for this fee and was not aware of any services that Scholander or Harris had performed for it.[14] Gearty asked Person C about how to "get this [$350,000] fee sent to First Merger." Per Person C's advice, Gearty formed a Delaware corporation also named First Merger ("First Merger Delaware") and, in early December 2009, opened a bank account for it to receive the fee. Gearty was the only person with signatory authority, but both she and Zakai were given debit cards, and Zakai's home address was the address of record. Gearty was tasked with opening the First Merger Delaware account because Zakai had "financial issues" that prevented him from doing so, and because Scholander and Harris informed her that they could not accept the $350,000 because they were still registered with Seaboard Securities. Gearty informed Scholander and Harris of the developments concerning the receipt of the fee, testifying that "I kept them updated on every minute of everything I did." After Gearty opened the bank account, Scholander asked her for wire instructions, which she understood Scholander planned to supply to DEER. On December 17, 2009, the account received $350,000 from DEER.[15]

E. Respondents and Zakai Spend the $350,000 in Furtherance of Their Plan to Acquire First Merger and Open a Branch Office

Immediately after the $350,000 was received in the First Merger Delaware account, Zakai, Scholander, and Harris began spending it in furtherance of their acquisition plan, which

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Scholander admitted that the law firm that purportedly released the funds without authorization had an existing lawyer-client relationship with him and later represented him at an on-the-record interview.

[14] On or around November 16, 2009—about two weeks after the China trip—a letter addressed to DEER's CEO was drafted on Brentworth letterhead, in which Brentworth proposed to provide "financial advisory services" to DEER in connection with a "possible public offering of common stock in a registered follow-on offering of $50 million or more" in exchange for a fixed $350,000 fee to be paid "within 5 days of the closing of the first Follow-on Offering in the amount of $50,000,000 or more in gross proceeds to [DEER]." There is no evidence, however, that the November 16, 2009 draft agreement was executed or sent, or that any "financial advisory services" were ever provided pursuant to it. Gearty believed that Person C drafted the letter but did not otherwise know how it was drawn up.

[15] One week before DEER made the $350,000 payment, DEER raised $75.9 million through an offering of six million shares of DEER stock. DEER did not disclose the $350,000 payment in any of its SEC filings.

included opening a branch office in New York City. Asked whether she spoke with Scholander and Harris about the use of the $350,000, Gearty testified, "Yes, of course, I did. It was their money. It wasn't mine." Gearty likewise testified that "I took my instructions from [Zakai, Harris, and Scholander]," that she "had to tell [Scholander and Harris] everything" concerning the expenses including "every transfer," and that Scholander and Harris would visit the new First Merger office space "almost every night . . . to see the . . . progress."[16]

Between December 21, 2009, and February 4, 2010, Gearty wrote numerous checks on the First Merger Delaware account in furtherance of the plan to acquire First Merger and open a branch office. According to Gearty, many of the payments were for expenses incurred pursuant to the direction of Scholander, Harris, or Zakai. These included payments to ACI and Person C, a communications company, a graphic designer, a receptionist, and a real estate broker. They also included payments for office furniture, pre-payment of rent, office construction, and Gearty's salary and Christmas bonus. Other checks reimbursed respondents for expenses they personally incurred while still registered with Seaboard Securities. Specifically, a $14,500 check that cleared on December 24, 2009, reimbursed Harris, via a payment to his personal credit card, for Manhattan gym memberships that he purchased for himself, Scholander, Zakai, and Person A. Harris viewed these expenses to be First Merger's. Likewise, a $6,075.46 check that cleared on January 27, 2010, paid Scholander for expenses he incurred in connection with the China trip. By February 4, 2010, the entire $350,000 received from DEER was spent, and soon thereafter First Merger Delaware's bank account was closed.

As the $350,000 was being spent, progress continued on other tasks in furtherance of the acquisition plan, including the final details involved with opening the branch office. On January 13, 2010, First Merger Capital and Gearty, evidently in her individual capacity, signed a branch agreement. On February 3 and 8, 2010, the graphic designer who was retained circulated draft business cards to Zakai, Harris, Scholander, and Gearty, in one instance corresponding directly with Harris. Pursuant to Zakai's instructions, the business cards indicated that Zakai, Scholander, and Harris each had the title of "managing partner," and that Gearty had the title of "operations manager." On February 5, 2010, Harris contributed $32,500 towards the acquisition—some of which came from him, and some from his mother—through a check written on First Auriga's bank account and made payable to RRZ Management.[17]

The First Merger branch office opened for business in February 2010. On February 9, 2010, respondents terminated their association with Seaboard Securities, and on February 11, 2010, registered with First Merger. Scholander and Harris brought many of the new branch office's registered representatives from Seaboard Securities. Zakai registered with First Merger

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[16] Scholander disputed that he monitored the expenses, and Harris disputed knowing how the funds were being spent.

[17] Harris testified that he thought the $32,500 would be deposited into an escrow account "for the future purchase of a broker-dealer," but there is no evidence that his payment went anywhere but to RRZ Management. RRZ Management paid the expenses of the branch office.

in early April 2010. Shortly after respondents moved to First Merger, Corporation P moved its offices to the same building.

F. Respondents Sell DEER Securities Without Disclosing the $350,000 Payment or Their Relationship with DEER

Seventy-eight percent of the new First Merger branch office's early revenues—commissions totaling more than $1.9 million—resulted from purchases and sales of securities issued by companies related to Person A and Person B. A substantial portion of this activity was in DEER stock. Specifically, from February 2010 through November 2010, 132 First Merger customers purchased $2,942,299 in DEER securities, and 11% ($273,770.05) of First Merger's gross revenues were generated from purchases and sales of DEER securities.[18] Over the same time period, Scholander, Harris, or both, were listed as representatives on 35 customer accounts that purchased $961,852.68 in DEER securities. Scholander and Harris generated $13,700 in gross commissions from these sales and also earned an unknown percentage of the commissions generated by other representatives' sales of DEER with whom they shared a "rep code."[19] Scholander and Harris admitted that, when soliciting purchases of DEER, they did not disclose to their customers the $350,000 payment from DEER.

G. Developments in Spring and Summer 2010

While respondents and other First Merger representatives were selling DEER securities, the purchasing group's efforts to acquire First Merger from Simonetti continued. Based on advice from new legal counsel, on June 21, 2010, RRZ Management formally assigned its right, title, and interest to purchase First Merger to Zakai, Scholander, Harris, and Gearty. Consistent with the overall acquisition plan that existed for months, Zakai, Scholander, and Harris were each assigned 33% of the ownership interests, and Gearty was assigned 1% of the interests. RRZ Management also assigned to Zakai, Scholander, Harris, and Gearty "all right title and interest to any and all cash representing the Purchase Price that has been previously paid by [RRZ Management] pursuant to the [October 13, 2009] Sale Agreement."

On August 17, 2010, Scholander, Harris, Zakai, and Gearty entered into an amended purchase agreement with Simonetti. Scholander, Harris, Zakai and Gearty agreed to "indemnify and hold harmless" Simonetti, in proportion to their ownership interests, for any losses incurred since October 13, 2009—the date of the original purchase agreement—related to any acts or omissions to act of the purchasing group.

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[18] Customer purchases of DEER stock were particular heavy between February 2010 through May 2010, when they ranged between 47% and 75% of all stock purchases at First Merger, and between October and November 2010, when First Merger customers purchased $1,343,874 in DEER securities.

[19] In June 2010, DEER management and Person B visited the new First Merger branch office.

On August 23, 2010, First Merger filed with FINRA a new application to change ownership. The application indicated that, after the change of ownership was effected, Zakai, Scholander, and Harris would each own 33% of First Merger, and that Gearty would own 1%. This was consistent with both the June 21, 2010 assignment and with the plan all along. In this regard, First Merger and the purchasing group represented at a continuing membership interview, through their lawyers, that the "true parties . . . involved in the ownership change" were Zakai, Scholander, Harris, and Gearty, notwithstanding that the original purchaser was RRZ Management. First Merger's application was never approved.

H. Respondents Fail to Disclose to Seaboard Securities Their Business Relationship with DEER or the $350,000 Fee

Scholander's visit to DEER, the conference calls with DEER, and DEER's payment of the $350,000 fee occurred when Scholander and Harris were registered with Seaboard Securities. It is undisputed that respondents did not provide Seaboard Securities prior written notice of the $350,000 received from DEER. Scholander never reported in writing to Seaboard Securities what he would be doing on his trip to China with Gearty, and never informed Seaboard Securities about the possibility of an offer of advisory fees of any kind from DEER. Instead, Scholander claimed that he verbally informed Seaboard Securities' compliance officer that his trip to China involved "a due diligence road show." Harris likewise testified that he never told Seaboard Securities about the advisory fee from DEER or any agreement to provide advisory services.

IV. Discussion

A. Fraud

The Hearing Panel found that Scholander and Harris solicited customers to purchase DEER stock while omitting material facts, in violation of Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, and FINRA Rules 2020 and 2010. We affirm.

Section 10(b) and Rule 10b-5 prohibit fraudulent and deceptive acts and practices in connection with the purchase or sale of a security. Section 10(b) of the Exchange Act makes it "unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." Exchange Act Rule 10b-5 makes it unlawful, in pertinent part, "[t]o make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading." To establish liability under these provisions requires proof that respondents: (1) made a material misrepresentation, or a material omission if the respondent had a duty to speak, or used a fraudulent device; (2) in connection with the purchase

or sale of a security; and (3) acted with scienter. *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1467 (2d Cir. 1996). We address each element below.[20]

1. Omission of Material Facts

A fundamental purpose of the federal securities laws is to "substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities business." *Richmark Capital Corp.*, 57 S.E.C. 1, 9 (2003) (internal quotation marks and citation omitted), *aff'd*, 86 F. App'x 744 (5th Cir. 2004). Liability for failing to disclose material information is "premised upon a duty arising from a relationship of trust and confidence between parties to a transaction." *Chiarella v. United States*, 445 U.S. 222, 230 (1980). "A registered representative owes such a duty to his clients to disclose material information fully and completely when recommending an investment." *Dep't of Mkt. Regulation v. Burch*, Complaint No. 2005000324301, 2011 FINRA Discip. LEXIS 16, at *23 (FINRA NAC July 28, 2011).[21]

Respondents concede that they solicited customers to purchase DEER stock without disclosing the $350,000 payment from DEER. They contend, however, that the payment was not material for a variety of reasons, including their contention that the $350,000 was allegedly only Gearty's money, and that they lacked a duty to disclose it because they were not fiduciaries. As

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[20] The complaint also alleges violations of FINRA Rule 2020 and 2010. FINRA Rule 2020 is FINRA's antifraud rule and is similar to, yet broader than, Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5. *See Dep't of Enforcement v. Fillet*, Complaint No. 2008011762801, 2013 FINRA Discip. LEXIS 26, at *38 (FINRA NAC Oct. 2, 2013) (explaining that FINRA Rule 2020 "captures a broader range of activity than Rule 10b-5(b)"), *appeal filed*, SEC Admin. Proceeding No. 3-15601 (Nov. 1, 2013); *Dep't of Enforcement v. Kesner*, Complaint No. 2005001729501, 2010 FINRA Discip. LEXIS 2, at *19 n.23 (FINRA NAC Feb. 26, 2010). Pursuant to FINRA Rule 0140(a), rules like FINRA Rule 2020 that apply to "members" are also applicable to associated persons. Conduct that violates other Commission or FINRA rules is inconsistent with high standards of commercial honor and just and equitable principles of trade and violates FINRA Rule 2010. *Joseph Abbondante*, 58 S.E.C. 1082, 1103 (2006), *aff'd*, 209 F. App'x 6 (2d Cir. 2006).

[21] *See also De Kwiatkowski v. Bear, Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002) (stating that on a "transaction-by-transaction basis, the broker . . . is obliged to give honest and complete information when recommending a purchase or sale"); *Magnum Corp. v. Lehman Bros. Kuhn Loeb, Inc.*, 794 F.2d 198, 200 (5th Cir. 1986) ("The law imposes upon the broker the duty to disclose to the customer information that is material and relevant to the order."); *Dep't of Mkt. Regulation v. Field*, Complaint No. CMS040202, 2008 FINRA Discip. LEXIS 63, at *32-33 (FINRA NAC Sept. 23, 2008) (holding that broker "had a duty to give full and complete disclosure" of material facts to his customers); *cf. Meyer Blinder*, 50 S.E.C. 1215, 1228 (1992) ("A broker-dealer, by holding itself out as a securities professional with special knowledge and ability, impliedly represents that it will deal fairly, honestly, and in accordance with industry standards with the public investor.") (citations omitted).

explained below, however, the record demonstrates that the $350,000 payment was primarily for respondents' and Zakai's benefit, not Gearty's, and that the payment, as well as respondents' business relationship with DEER, were material facts that respondents had a duty to disclose when selling DEER securities.

a. The $350,000 Payment from DEER Was Used by Scholander, Harris, and Zakai in Furtherance of Their Plan to Acquire a Broker-Dealer

The record demonstrates that the $350,000 payment from DEER was almost entirely for the benefit of Scholander, Harris, and Zakai. To start, Gearty—whom the Hearing Panel found to be credible "both because of the level of detail" and her testimony's consistency with the other evidence—testified about how Scholander, Harris, and Zakai were either directly involved in planning the visit to DEER's offices, or familiar with the fact that the trip would lead to a fee. In this regard, Scholander informed Gearty that she would be going to China, he purchased her airline tickets on his personal credit card, and Scholander, Harris, and Zakai all informed her that they would be earning a "fee" in China.

The record also demonstrates that Scholander and Harris provided services for the $350,000 fee, albeit very limited ones. Scholander admitted during an on-the-record interview that he and Harris provided DEER with certain advisory services to earn the $350,000, including advice provided by Scholander during his trip to China and opinions provided by Scholander and Harris during their participation on conference calls. And Harris testified—in testimony that cuts against respondents' overall argument that they had nothing to do with the fee—that the arrangement to provide consulting services was "between [Gearty] and [DEER] *and First Merger*."[22] (Emphasis added.)

The way in which the $350,000 was initially handled further demonstrates that Scholander and Harris were among the primary beneficiaries. For example, Scholander facilitated the receiving of the fee by asking Gearty for wire instructions that he planned to give to DEER. As another example, Harris testified that questions about whether the $350,000 could be spent were considered collectively. In this regard, Harris noted that "we"—meaning "the whole firm"—"were all expecting that [DEER] would come back and ask for some kind of advice" and that, as a result, "there was some skepticism at first" about whether to spend the $350,000.

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[22] The record is inconsistent regarding whether Gearty also provided any services in connection with the fee. Gearty testified at the hearing that, during her visit to DEER, she looked at DEER's kitchen appliance products, that no one asked her for any advice "of any nature," and that she did not provide any kind of advisory services, financial or otherwise, about anything. At a prior continuing membership interview, however, Gearty testified that she offered her opinions about DEER's appliances during her visit to DEER's offices. Gearty was never asked at the hearing to explain the discrepancies in her statements about the services she provided. In any event, even if Gearty did provide some limited services in connection with the fee, the record does not support a finding that only she performed the services that led to the fee.

Furthermore, once they got over their "skepticism," Scholander, Harris, and Zakai treated the $350,000 as theirs to spend, and Scholander and Harris oversaw how it was spent. Gearty testified that the $350,000 was not hers but that of Scholander, Harris, and Zakai, that it was "completely understood" that the $350,000 would be used in connection with the plan to acquire First Merger, and that respondents and Zakai directed her to spend it in furtherance of the acquisition plan on various items and services. Gearty testified that she told Scholander and Harris "everything" concerning the expenses, that they "knew about every transfer out" of the First Merger Delaware account, and that she spoke with respondents "every single day" to report on her progress.

Finally, the $350,000 was spent on expenses related to the acquisition of a firm of which Scholander, Harris, and Zakai always expected to own one-third interests. Indeed, before the $350,000 was received, the purchasing group had already taken several concrete steps towards acquiring their ownership interests, including meeting with First Merger's owner, establishing companies to facilitate the acquisition, making financial contributions towards the acquisition, and entering into the purchase agreement.[23] Harris conceded that, by December 24, 2009—days after the fee was received—Zakai and Gearty "were already determined to be [his] future partners." In addition, draft business cards were later produced showing that Scholander, Harris, and Zakai each had the title of "managing partner," further evidencing their expected ownership interests. Consistent with the ownership structure that was planned all along, the purchasing group ultimately executed a written agreement that formally assigned 33% of the ownership interests in First Merger each to Scholander, Harris, Zakai, and 1% to Gearty. And the fact that the purchasing group ultimately agreed to indemnify Simonetti for any losses related to any of their acts or omissions after October 13, 2009, further shows that as early as October 2009—and during the time they spent the $350,000 to establish a First Merger branch office—respondents already considered their actions to be those of First Merger.

All of this evidence points to the conclusion that Scholander and Harris were among the primary beneficiaries of the $350,000 payment.

b. Scholander's and Harris' Hearing Testimony About the $350,000 Payment Was Not Credible

Respondents contend that they did nothing to earn the $350,000, and that it was solely Gearty's money. The Hearing Panel found, however, that Scholander's and Harris' testimony about the $350,000 payment was inconsistent with the evidence and not credible. The Hearing Panel's credibility determinations are entitled to considerable weight and deference and can only be overturned by "substantial evidence." *John Montelbano*, 56 S.E.C. 76, 89 (2003). Respondents have not pointed to substantial evidence that would warrant overturning the Hearing Panel's determinations that they were not credible.

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[23] Although the original purchase agreement was entered into by "RRZ Management," First Merger admitted during a continuing membership interview that Scholander, Harris, Zakai, and Gearty were always the "true parties . . . involved in the ownership change."

The version of events that Scholander provided at the hearing was as follows. Person B proposed to Scholander, in front of Gearty, that he go to China to attend a "due diligence road show." Person B then said to Gearty, and "totally out of [Scholander's] hearing," "[m]aybe you can do something for DEER over there," and provided to Gearty alone "a chance to provide advisory services to DEER for a fee." At one point during their two-hour visit to DEER's offices, Scholander was separated from Gearty and stayed in DEER's showroom with DEER's appliance products and "a lot of bankers." Gearty went with a "big, larger group . . . to another section and then didn't come back for a while." Scholander's purported belief was that when he and Gearty were separated, Gearty "provided all of the services that led DEER to pay her $350,000" and that there was a consulting agreement between DEER and Gearty alone. Scholander claimed to be unaware of what Gearty did to earn the fee and to have not learned about the fee until January 2010.

Harris claimed that he did not know anything about the fee before the China trip occurred, did not learn about the fee until early January 2010, and that the $350,000 fee "belonged to Gearty alone." Harris' understanding was "that [Gearty] went to China, . . . was there with [DEER], . . . was offered some kind of consulting arrangement with them to—on product analysis and launching product in the United States," and would be "setting up products for [DEER]." Harris also testified that he never had access to the $350,000.

As the Hearing Panel found, however, respondents' testimony that the $350,000 payment was only Gearty's money is implausible for numerous reasons. To start, Gearty was a back office manager, had never been to China, had never provided advice to a foreign company regarding product sales, had no previous contact with DEER before her trip, and had no prior business connections to either Person A or Person B, at least one of whom was involved with facilitating the China trip. By contrast, Scholander and Harris had a pre-existing connection with DEER that stemmed from their longstanding, close business relationship with Person A and Person B, and the trip was similar to past trips to China that Scholander or Harris had taken as a result of that relationship.

In addition, respondents offer no reasonable explanation about what Gearty did, or was supposed to do, to earn the $350,000. Scholander's suggestion that Gearty somehow earned the entire $350,000 in less than two hours from a company with which she had no prior contact, and despite no relevant expertise, is not believable. Even if Gearty offered some advice on DEER's kitchen appliance products while in China, the suggestion that Gearty was the sole source of advisory services worth $350,000 is implausible.

Moreover, the use of the $350,000 was inconsistent with it being Gearty's fee. Much of the $350,000 was used to pay expenses associated with opening the First Merger branch office and acquiring First Merger, of which Gearty was to own just one percent. Respondents' suggestion that Gearty personally committed $350,000 towards the acquisition of First Merger—more than five times Scholander's financial contribution and more than ten times Harris' financial contribution—simply makes no sense, considering that she expected to own only one percent of First Merger.

Scholander's testimony that he went to China to conduct "due diligence" on DEER also does not withstand scrutiny. All Scholander did was visit DEER's offices for two hours, look at

its kitchen appliance products, and visit a mall to see a DEER display. He did not visit with DEER executives or visit any factories.[24]

Scholander's lack of credibility is further demonstrated by how his story about the fee changed over time. His hearing testimony that he had nothing to do with the $350,000 fee was at complete odds with his earlier investigative testimony that he, Harris, Zakai, and Gearty provided some advice to DEER in exchange for the $350,000 fee.[25] Similarly, Harris gave testimony, both at his on-the-record interview and at the hearing, about his purported limited involvement with First Merger that was demonstrably false. Harris testified at a July 2010 on-the-record interview that he had not put any money towards funding First Merger. In fact, just four months before, he had made a financial contribution. As another example, Harris claimed that he did not know how the $350,000 was spent, but in at least one instance—the reimbursement he received for the gym memberships he purchased—that was demonstrably false. For all of these reasons, respondents have not pointed to substantial evidence that would warrant overturning the Hearing Panel's determination that they were not credible. In sum, respondents' testimony that the $350,000 was a fee paid only to Gearty is, as the Hearing Panel found, not believable and contradicted by the evidence.[26]

c. Respondents' Challenges to Gearty's Testimony

Respondents also claim that the Hearing Panel incorrectly found Gearty to be credible. In support, respondents note that Gearty testified during an on-the-record interview that Person B approached her about the China trip, but changed her story at the hearing and testified that it was Person A instead. When respondents' counsel asked Gearty at the hearing whether she was "mistaken or . . . lying" during her on-the-record interview about this point, Gearty admitted that she lied.

This, however, is not substantial evidence to warrant ignoring the Hearing Panel's determination that Gearty was credible. Gearty testified that she did not previously disclose Person A's involvement with the China trip because "I was intimidated and . . . in fear of my

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[24] Scholander asserts in his appellate brief that the purpose of his due diligence trip was to "ensure that [DEER] was in fact producing the goods it purported to make." But he never testified that this was the reason for his trip. Moreover, Scholander was already selling DEER stock to his Seaboard Securities customers and, presumably, had no questions at that time about whether DEER was actually making appliance products.

[25] At the hearing, Scholander tried to explain the discrepancies by saying that he must have been "confused" at his on-the-record interview and that, when he testified about the advice and opinions "we" provided in connection with the fee, he was speaking in the "royal we," as in First Merger as a whole. But it is not credible that Scholander was confused at the on-the-record interview because Scholander was expressly asked about his own personal conduct.

[26] The Hearing Panel found that Gearty's testimony was "unnecessary to finding Respondents' version of events . . . false." We agree.

potential partners [Scholander, Harris, and Zakai], so I did exactly what they told me to do" which was "to leave [Person A] out of this [on-the-record interview]." As the Hearing Panel correctly noted, Gearty's "expression of fear is not outlandish" considering that in March 1989, Scholander pleaded guilty in New York to the charge of Menancing, a Class B misdemeanor, and received 100 hours of community service.[27] Moreover, respondents' argument is essentially an attempt to relitigate Gearty's credibility before us. Respondents' point—that Gearty changed her testimony—was front and center before the Hearing Panel. The Hearing Panel's credibility determination that Gearty's testimony at the hearing was credible, in spite of her previous dishonest statement, is a credibility determination that finders of fact make routinely in cases where the facts are vigorously disputed. For these reasons, although Gearty did not initially tell the truth about who approached her about the China trip, it does not cause us to question the Hearing Panel's assessment of Gearty's overall credibility.

In a further effort to attack Gearty's credibility, respondents filed two motions. As explained below, both motions are denied.

i. Respondents' Motion to Dismiss or for a New Hearing

In respondents' first motion, respondents argue that, pursuant to *Brady v. Maryland* and *Giglio v. United States*, Enforcement was required to alert respondents before the hearing that Gearty falsely testified during her on-the-record interview that Person B approached her about the China trip, but that Enforcement failed to do so. For this purported procedural violation, respondents move that the proceeding be dismissed or, alternatively, that a new hearing be held. We deny respondents' motion.

In *Brady v. Maryland*, the Supreme Court held that "the suppression by the prosecution of evidence favorable to an accused upon request violates due process where the evidence is material either to guilt or to punishment, irrespective of the good faith or bad faith of the prosecution." 373 U.S. 83, 87 (1963). In *Giglio*, the Supreme Court held that impeachment evidence falls within the *Brady* doctrine. 405 U.S. 150, 154-155 (1972). The Court held that "[w]hen the reliability of a given witness may well be determinative of guilt or innocence, nondisclosure of evidence affecting credibility falls within [the *Brady*] rule," and a new trial is warranted if "the false testimony could . . . in any reasonable likelihood have affected the judgment of the jury." *Id.* at 154 (internal quotation marks omitted).

Brady and *Giglio* apply to criminal matters, however, not FINRA disciplinary proceedings. *See Dist. Bus. Conduct Comm. v. Pac. S. Sec., Inc.*, Complaint No. CMS910204, 1993 NASD Discip. LEXIS 295, at *28 n.5 (NASD NBCC Sept. 2, 1993). Instead, FINRA rules set forth the scope of Enforcement's responsibilities concerning exculpatory evidence. Specifically, FINRA Rule 9251(b)(3) provides that "nothing in [FINRA Rule 9251(b)(1)]," which governs what documents FINRA may withhold from a discovery production pursuant to

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[27] In New York, a person is guilty of menacing "when, by physical menace, he or she intentionally places or attempts to place another person in fear of death, imminent serious physical injury or physical injury." N.Y. Penal § 120.15 (2014).

FINRA Rule 9251, "authorizes [Enforcement] . . . to withhold a Document . . . that contains material exculpatory evidence."

Even assuming that the information about Gearty's prior testimony was a "Document" within the meaning and scope of FINRA Rule 9251(b)(3),[28] it was not "material exculpatory evidence." Who approached Gearty about the China trip is immaterial to the allegations—and to Gearty's overall credibility—because the material issues are whether respondents were beneficiaries of the $350,000 fee and whether they had a business relationship with DEER. Moreover, even if Enforcement had an obligation to disclose the information to respondents, there was no prejudice. The issue of Gearty's prior false testimony emerged at the hearing, and respondents were able to cross-examine Gearty about it. *Cf.* 25-616 *Moore's Federal Practice -- Criminal Procedure* § 616.06 (2014) (explaining that, under *Brady* and *Giglio*, "if the evidence is valuable only for impeachment purposes, then disclosure is required to be made in time for the defense to use it in cross-examination"). Accordingly, we deny respondents' motion to dismiss or for a new hearing.

ii. Respondents' Motion to Introduce Additional Evidence

In a further attempt to attack Gearty's credibility, respondents moved on appeal to introduce four items of additional evidence: (1) a grand jury indictment dated July 18, 2013, of Zakai, alleging that he stole, from December 2010 through January 2012, $705,000 from five victims seeking to invest in the initial public offering of Facebook, Inc. through a venture called "The Social Innovation Fund"; (2) the Manhattan District Attorney's related press release of July 18, 2013; (3) a related New York Daily News article of July 18, 2013; and (4) a private placement memorandum in connection with The Social Innovation Fund, dated March 15, 2011. Respondents claim that the additional evidence is material because it "exposes statements that [Gearty] made about [T]he Social Innovation Fund during the hearing as false and it shows that she was engaged in an ongoing fraud, both during the investigation of First Merger Capital . . . and during the . . . hearing."

Pursuant to FINRA Rule 9346(b), a party seeking leave to introduce additional evidence on appeal must demonstrate, among other things, why the evidence is material. Contrary to respondents' arguments, the proposed evidence is not material to Gearty's credibility. Gearty testified at the hearing that The Social Innovation Fund was planned to be a private placement offered through First Merger, that it was going to be done by Zakai and her, but that "[i]t never was." As Enforcement correctly argues, there is no suggestion in Zakai's indictment or the press releases that The Social Innovation Fund was offered by Zakai as a private placement through First Merger, that Gearty had any involvement with the alleged fraud, or that Gearty was even aware of it. Although respondents claim that the private placement memorandum indicates that Gearty held various roles in connection with The Social Innovation Fund (i.e., Head of Trading, Operations & Administration," "a member of the Board of Managers of the Manager," and "an

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[28] *See* FINRA Rule 9251(a)(1) (providing that FINRA's discovery rule applies only to "Documents" that were "prepared or obtained by Interested FINRA Staff in connection with the investigation that led to the institution of proceedings").

interest holder of the Class B member") and therefore "should have had direct knowledge of [T]he Social Innovation Fund's operations and solicitation of investors," respondents have offered no evidence about the private placement memorandum itself, such as whether it was ever used. Accordingly, we deny respondents' motion to introduce additional evidence.

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For the reasons explained above, we find that the $350,000 payment was primarily for the benefit of Scholander, Harris, and Zakai, and we reject respondents' assertion that the payment was only Gearty's money. Having addressed those critical factual issues, we turn to the issue of materiality.

d. The $350,000 Payment and Respondents' Business Relationship with DEER Were Material Facts

An omitted fact is "material" if there is a substantial likelihood that a reasonable investor would have considered the omitted fact important in making an investment decision, and if "disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988); *TSC Indus. Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). Material adverse facts that registered representatives are required to disclose include "any self-interest that could influence the salesman's recommendation." *Richard H. Morrow*, 53 S.E.C. 772, 781-84 (1998) (finding that salesman, who recommended interests in a limited partnership while being compensated by that partnership's general partner with commissions and an "equity kicker," "might not be wholly disinterested" and that "[w]hen recommending securities to a prospective investor, a securities professional must . . . disclose 'material adverse facts,' including any self-interest that could influence the salesman's recommendation").[29]

When soliciting customers to purchase DEER securities, Scholander and Harris had potentially competing motivations due to their business relationship with DEER. DEER funded, through the $350,000 payment, Scholander's and Harris' plans to acquire First Merger and the opening of their First Merger branch office. While the full extent of the services that respondents were required to provide in exchange for DEER's $350,000 payment is unclear, it is reasonable to infer that DEER did not make the $350,000 payment for no reason at all, and that the limited "advisory services" that Scholander and Harris provided were not the only services

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[29] *See also Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153 (1972) (holding that defendants' market-maker status was a material fact because sellers "had the right to know that the defendants were in a position to gain financially from their sales and that their shares were selling for a higher price" in the market that defendants developed); *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970) (holding that broker's failure to disclose adverse interests was an omission of a material fact); *Richmark Capital Corp.*, 57 S.E.C. at 9, 11 (holding that when a securities dealer recommends stock to a customer, it "must disclose material adverse facts of which it is aware," including "'adverse interests' such as 'economic self interest' that could have influenced its recommendation").

that DEER expected for its money. Moreover, DEER was a potentially lucrative source of business for respondents. Respondents previously handled two private placements for DEER and, just three months before they began selling DEER securities at First Merger, attempted to secure a contract with DEER to provide advisory services in connection with DEER's follow-on offering.

Respondents' competing motivations were potentially even stronger considering that their dealings with DEER resulted from respondents' longstanding business relationship with Person A and Person B, who over the years introduced respondents to several Chinese companies, including DEER. Indeed, the fact that most of First Merger's early revenues—totaling more than $1.9 million—resulted from purchase and sale activity involving stocks of issuers, like DEER, that were connected to Person A or Person B demonstrates the lucrative nature of respondents' ties to Person A and Person B and the financial self-interests created by that relationship.

Reasonable investors would have considered these facts important in deciding whether to purchase DEER securities through Scholander and Harris, and disclosure would have significantly altered the total mix of information available. Scholander's and Harris' failure to disclose the $350,000 payment from, and business relationship with, DEER deprived each customer of "the knowledge that his registered representative might be recommending a security based upon the registered representative's own financial interest rather than the investment value of the recommended security." *SEC v. Hasho*, 784 F. Supp. 1059, 1110 (S.D.N.Y. 1992); *see also Chasins*, 438 F.2d at 1172 (stating that "[t]he investor . . . must be permitted to evaluate overlapping motivations through appropriate disclosures, especially where one motivation is economic self-interest"); *Richmark Capital Corp.*, 57 S.E.C. at 9, 11 (holding that respondents were required to disclose to customers their "strong financial motivation" to promote sales of a stock, a consequence of respondents' compensation under an investment banking agreement with the issuer, "so that investors could make an informed judgment"); *Burch*, 2011 FINRA Discip. LEXIS 16, at *31 (finding that respondent was required to disclose to customers that his wife was selling the same stock that he was recommending to have "the opportunity to question whether [respondent] had a genuine, objective belief that the investment . . . was in their best interest"); *Dep't of Mkt. Regulation v. Jaloza*, Complaint No. 2005000127502, 2009 FINRA Discip. LEXIS 6, at *20 (FINRA NAC July 28, 2009) (finding that respondent's omission of his "member firm's interest in promoting the stock," which related to the firm's potential consulting relationship with the issuer, the firm's holdings in the stock, and the firm's intention to become a market maker in the stock, was material because it had the potential to affect respondent's "objectivity"). For example, respondents' customers had no idea that respondents had conflicts that may have caused them to recommend DEER instead of other investments in the same or similar sector as DEER that might have been as suitable or even more so.

The case of *Kevin D. Kunz*, 55 S.E.C. 551 (2002), *aff'd*, 64 F. App'x 659 (10th Cir. 2003), is a relevant analogy. In that case, the Commission found that the applicant and the broker-dealer he formed sold an issuer's investment instruments using private placement memoranda that did not disclose that the applicant and the broker-dealer had a consulting relationship with the issuer, that they had received consulting fees from the issuer, and that the issuer financed the broker-dealer itself. *Id.* at 565. The Commission held that "[t]he existence of these relationships would have been material to any prospective investor" and that "[w]hen a

broker-dealer has a self-interest (other than the regular expectation of a commission) in serving the issuer that could influence its recommendation, it is material and should be disclosed." *Id.*

Respondents argue that *Kunz* is distinguishable on the grounds that the securities involved in *Kunz* were "newly issued," that the issuer and its broker had "absolute control over the market and pricing" of the securities, that there was evidence the broker-dealer was the issuer's "captured broker," and that there was "arguably a duty to disclose in the [private placement memoranda]" the "potential conflict relationship." Along these same lines, respondents argue that they recommended DEER stock because it was fundamentally sound, widely held, and followed by large Wall Street firms, and that the $350,000 was not material because DEER "isn't some little fly-by-night company" and the payment did not affect the value of the securities. Even if the broker's interest in serving the issuer in *Kunz* was stronger in degree than here, *Kunz* nonetheless shows that a broker's business relationship with an issuer, which includes the issuer's funding of the broker-dealer, can give rise to a material conflict of interest that should be disclosed when the broker sells the issuer's securities. Moreover, even if respondents sold DEER stock purely because of its fundamentals, the materiality of the $350,000 payment is not based on whether it actually affected the respondents' actions or the value of DEER stock, but on whether reasonable customers would have considered the information important when deciding whether to invest in DEER stock. Respondents' omissions prevented their customers from evaluating Scholander's and Harris' potentially overlapping motivations when recommending DEER securities and deprived those customers from knowing that there may be a significant reason to consider other investments besides DEER.[30]

Respondents' other arguments concerning materiality are also unpersuasive. Respondents argue that some of the $350,000 went to pay Zakai's personal expenses, that the $350,000 was spent before respondents registered at First Merger, and that they were not owners of First Merger when they registered. These facts, however, do not change that Scholander and Harris were also primary, and recent, beneficiaries of the $350,000 when they sold DEER securities. Moreover, although the $350,000 was fully spent, it appears, based on the limited amount of services that were provided for the $350,000, that there was a continuing business relationship between First Merger and DEER when respondents were soliciting purchases of DEER stock.

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[30] Despite overwhelming authorities such as *Kunz* that hold that a broker has a duty to disclose adverse economic interests when selling securities to customers, respondents cite *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 170 (2d Cir. 2005), for the proposition that "a failure to disclose a conflict of interest alone is not fraud." But the passage in *Lentell* that respondents cite addressed whether "numerous generic articles" in the financial press "on the subject of structural conflicts" that generally existed between research analysts and investment bankers gave the plaintiffs a duty to inquire into facts constituting the alleged issuance of false and misleading research reports. *Lentell* did not address a registered representative's reckless or intentional failure to disclose material information to customers when there was a duty to do so, let alone economic self-interests as specific as the ones at issue in this case.

Now calling the issue of whether they benefitted from the $350,000 fee a "giant red herring," respondents argue that, even if they received the benefit of the entire fee, they were not required to disclose that they were receiving "added compensation" or "financial incentives" for promoting or selling an investment, citing *United States v. Skelly*, 442 F.3d 94 (2d Cir. 2006). Respondents' reliance on *Skelly*, however, is misplaced. *Skelly* concerned primary allegations that principals of a broker-dealer engaged in a "pump and dump" scheme concerning certain thinly traded securities and alternative allegations that the principals failed to disclose that their broker-dealer "paid its registered representatives . . . far more if they sold the manipulated securities . . . than if they sold other securities." *Id.* at 96-97. With respect to those alternative allegations, the court of appeals noted that "a seller or middleman may be liable for fraud if he lies to the purchaser or tells him misleading half-truths, but not if he simply fails to disclose information that he is under no obligation to reveal." *Id.* at 97. The court continued that "a registered representative is under no inherent duty to reveal his compensation" and that "otherwise truthful statements . . . about the merits of a particular investment are not transformed into misleading 'half-truths' simply by the broker's failure to reveal that he is receiving added compensation for promoting a particular investment." *Id.* *Skelly* further explained that a registered representative can only be convicted for failing to disclose information about his "added compensation" if he "assumed a 'fiduciary duty' to disclose such information." *Id.* at 98. Respondents argue that because their customers were purportedly "sophisticated," "accredited" investors "who could fend for themselves" and who did not give respondents discretionary authority, respondents did not have a "fiduciary duty or its functional equivalent" and, pursuant to *Skelly*, had no duty to disclose the $350,000.

Unlike the "added compensation" at issue in *Skelly*, however, respondents have offered no proof that the $350,000 was compensation for selling stock. Scholander, Harris, and Gearty never testified that the advisory services were related in any way to sales of DEER stock. Gearty testified that she did not know what the payment was for (other than for possibly limited product advice), and Scholander testified at an on-the-record interview that the payment was for "advisory services" to DEER. Thus, unlike the heightened, transaction-based compensation paid by a broker-dealer to its representatives for sales of "house stocks" at issue in *Skelly*, the $350,000 payment from DEER reflected a single, substantial, non-transaction-based payment from an issuer in exchange for consulting services, which Scholander and Harris used to try to acquire a broker-dealer and to establish a branch office from which they sold the issuer's securities. Reasonable customers expect that their brokers will receive compensation from their employing firms for sales of stocks. Reasonable customers do not necessarily expect, however, that their broker is receiving advisory fees from the issuer of the securities he recommends, has a close and possibly ongoing business relationship with the issuer, or has longstanding and lucrative ties to the issuer's promoters. Thus, the $350,000 payment and respondents' relationship with DEER is not the kind of information that respondents were required to disclose only if they assumed a "fiduciary duty" to their customers; rather, they were material, adverse interests that respondents were required to disclose even absent a fiduciary duty.[31]

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[31] Even if the $350,000 was compensation for selling DEER stock—and there is no evidence it was—a registered representative has an obligation to disclose compensation in

[Footnote continued on next page]

In a similar argument, respondents argue that they had no "duty to disclose" the payment because they had no "fiduciary duty" or "its 'functional equivalent,' a duty of trust and confidence." But as demonstrated above, liability for failing to disclose material information is "premised upon a duty arising from a relationship of trust and confidence between parties to a transaction,"[32] and numerous cases hold that, on a transaction by transaction basis, a broker *has* a duty to disclose material facts when selling securities to a prospective investor. Scholander and Harris recommended purchasing DEER and had a duty to disclose. Indeed, apart from *Skelly*, which is distinguishable for the reasons explained above, none of the authorities cited by respondents in support of this particular argument, such as *Matrixx*, *Dirks*, *De Kwiatkowski*, or *Chestman*, involved allegations of fraudulent omissions by registered representatives when recommending securities to customers.[33]

Therefore, for the reasons discussed above, the $350,000 payment from DEER and respondents' business relationship with DEER were material facts that respondents were required to disclose to the customers to whom they sold DEER securities.

[Cont'd]

circumstances that are not "ordinary." *See Dep't of Enforcement v. Meyers*, Complaint No. C3A040023, 2007 NASD Discip. LEXIS 4, at *22, 24 (NASD NAC Jan. 23, 2007) (finding that respondents' "undisclosed sales incentives . . . as high as 10 times the disclosed mark-ups" were "far above the norm" and material facts). Assuming that Scholander and Harris was each a one-third beneficiary of the $350,000 payment, $231,000 in "compensation" was more than 16 times the $13,700 in gross commissions that respondents generated selling DEER stock between February 2010 and November 2010. Moreover, $244,700 in total compensation ($231,000 plus $13,700) amounted to more than 25% of the $961,852 that respondents sold in DEER securities during the relevant period. That kind of compensation for selling stock was not ordinary and was required to be disclosed by respondents, even absent a fiduciary relationship with their customers.

32 *Chiarella*, 445 U.S. at 230.

33 *See Matrixx Initiatives, Inc.*, 131 S. Ct. 1309 (2011) (concerning omissions by an issuer relating to adverse events associated with a drug); *Dirks v. SEC*, 463 U.S. 646 (1983) (concerning allegations that officer of a broker-dealer was liable as a tippee for trading on material non-public information received from a company insider); *De Kwiatkowski*, 306 F.3d 1293 (concerning allegations that a futures commission merchant owed a duty to provide ongoing advice and risk warnings to a nondiscretionary customer); *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (concerning allegations that stockbroker aided and abetted the misappropriation of inside information and engaged in fraud as tippee of the misappropriated information).

2. "In Connection With" the Offer, Sale, or Purchase of Securities

To establish liability under Section 10(b) and Rule 10b-5 requires proof that respondents engaged in fraudulent conduct "in connection with the offer, sale, or purchase of securities." The Supreme Court has embraced an expansive interpretation of Exchange Act Section 10(b)'s "in connection with" language. *See, e.g., Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 85 (2006); *SEC v. Zandford*, 535 U.S. 813, 819 (2002).

The "in connection with" requirement is met here. Respondents failed to disclose the $350,000 payment from DEER when soliciting purchases of DEER stock from customers, and those omitted facts were material to reasonable investors. Respondents' breach of their duty to disclose the $350,000 payment and the securities transactions coincided. *See Zandford*, 535 U.S. at 822 ("It is enough that the scheme to defraud and the sale of securities coincide.").[34]

3. Scienter

a. Respondents Acted at Least Recklessly

Liability under the anti-fraud provisions also requires a showing of scienter. Scienter is defined as "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976). Scienter may be established by a showing that the respondent acted recklessly. "[R]ecklessness in this context is a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Alvin W. Gebhart*, Exchange Act Release No. 58951, 2008 SEC LEXIS 3142, at *26 (Nov. 14, 2008) (internal quotation marks omitted) (citing cases), *aff'd*, 595 F.3d 1034 (9th Cir. 2010); *see also SEC v. Fife*, 311 F.3d 1, 9 (5th Cir. 2002). Proof of scienter may be "a matter of inference from circumstantial evidence." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390-91 n.30 (1983); *Derek DuBois*, 56 S.E.C. 829, 836 (2003).

The record demonstrates that respondents acted at least recklessly, and with scienter, when, in selling DEER securities, they omitted disclosing information about the $350,000 payment and their business relationship with DEER. Respondents knew about the $350,000 payment, that they were among the primary beneficiaries of the $350,000 payment, and that their customers were not aware of either the payment or respondents' relationship with DEER. Respondents also must have known that both the payment and their ongoing business

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[34] The fact that the $350,000 payment did not concern the value of DEER securities does not preclude a finding that respondents' omissions were "in connection with" the sale or purchase of securities. *See Marc Geman*, 54 S.E.C. 1226, 1244-45 & n.40 (Feb. 14, 2001) (citing cases) (noting that "[t]he plain meaning of the [in connection with element] is that, for a deceptive practice to constitute a violation of the antifraud provisions, it need only be directly related to securities transactions, not necessarily to the securities themselves or their value"), *aff'd*, 334 F.3d 1183 (10th Cir. 2003).

relationship with DEER gave them obvious conflicts of interest that had the potential to influence their decision of what securities to recommend to their customers. Despite this, respondents failed to disclose information about the fee or their relationship with DEER to the customers whom they solicited to buy DEER securities. This was a highly unreasonable omission that presented a danger of misleading customers that respondents had no competing motivations for soliciting purchases of DEER stock. *See GSC Partners CDO Fund v. Washington*, 368 F.3d 228, 239 (3d Cir. 2004) ("It is certainly true that in a non-disclosure situation, any required element of scienter is satisfied where . . . the defendant had actual knowledge of the material information.") (citation omitted); *see also Gebhart*, 2008 SEC LEXIS 3142, at *26 (explaining that scienter exists when the omission "presents a danger of misleading buyers . . . that is either known to the defendant or so obvious that the defendant must have been aware of it"); *Kenneth R. Ward*, Exchange Act Release No. 47535, 2003 SEC LEXIS 3175, at *40 (Mar. 19, 2003) (finding scienter established when representative was aware of material information and failed to make appropriate disclosures to customers), *aff'd*, 75 F. App'x 320 (5th Cir. 2003).

The fact that each respondent had significant industry experience only bolsters the finding of recklessness. *See Peter Siris*, Exchange Act Release No. 71068, 2013 SEC LEXIS 3924, at *24 (Dec. 12, 2013) (finding that respondent's "long experience in the industry" made it "particularly true" that he acted intentionally or with severe recklessness when he engaged in repeated instances of insider trading); *Dolphin and Bradbury, Inc.*, Exchange Act Release No. 54143, 2006 SEC LEXIS 1592, at *43-44 (July 13, 2006) (citing respondents' experience in support of findings that they acted with scienter), *aff'd*, 512 F.3d 634 (D.C. Cir. 2008); *Jay Houston Meadows*, 52 S.E.C. 778, 786 (1996) (citing securities industry experience of respondent registered representative in support of finding of scienter), *aff'd*, 119 F.3d 1219 (5th Cir. 1997).

b. Respondents' Arguments That They Lacked Scienter Are Meritless

Respondents make several arguments that they lacked scienter, but none is persuasive. Citing *In re Canadaigua Securities Litigation*, 944 F. Supp. 1202 (S.D.N.Y. 1996), respondents contend that scienter requires "more than simple conscious nondisclosure" and that, therefore, their mere knowledge of the $350,000 fee is insufficient to demonstrate scienter. *Canadaigua*, however, is distinguishable. In *Canadaigua*, the court found that plaintiffs, purchasers of the defendant company's stock, failed to show particularized facts that defendants, a company and two of its officers, acted with scienter when they did not publicly disclose information about a pricing plan for a new product line. The court noted, among other things, that plaintiffs failed to point to any prior statements or omissions by defendants that were false or misleading and that defendants had "legitimate competitive business reasons . . . to keep their own counsel on the pricing of their new product line." *Id.* at 1213-1214. In contrast, Scholander's and Harris' failure to disclose the $350,000 payment and their relationship with DEER left the materially misleading impression that respondents had no potential self-interest in the DEER transactions, and respondents, as registered representatives of a broker-dealer that solicited transactions in

DEER, had a duty to disclose material adverse interests to their customers, not to "keep their own counsel."[35]

Respondents also argue that Enforcement has not presented "a scheme or motivation connected to defrauding customers." Scienter can be demonstrated, however, by a showing of recklessness, and the evidence here demonstrates that respondents' omission of the $350,000 payment and their relationship with DEER presented an obvious danger of misleading their customers.

Respondents next contend that they were "subordinate sales persons" who "possessed a good faith belief that no fee disclosure was required." They similarly argue that, when selling DEER securities at First Merger, the $350,000 "had been completely spent" and was the "furthest thing from their minds." These arguments, however, do not show that respondents lacked scienter. While evidence of good faith is "relevant to a determination of whether a respondent acted with the requisite state of mind," the "reasonableness and, therefore, the credibility of that claim of good faith must be evaluated in light of the circumstances of each case and in light of the conduct expected from a reasonable person." *Gebhart*, 2008 SEC LEXIS 3142, at *34. Notwithstanding their arguments, respondents did not *testify* that their purported good faith belief was somehow grounded in their status as "subordinate sales persons" or that the $350,000 payment was "the furthest thing from their minds." Rather, their position was that disclosure was not necessary because of their purported belief that the $350,000 payment was not theirs, a factual claim that we have rejected. And any claim that respondents forgot about the payment further lacks credibility because the $350,000 was spent just days before respondents began soliciting sales of DEER stock. Thus, respondents' purported good faith beliefs do not establish that they lacked scienter.

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[35] In a similar argument, respondents argue that "non disclosure of the Fee" cannot be "in and of itself the fraud," citing *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124 (2d Cir. 1994). Respondents also cite *In re Criimi Mae, Inc. Securities Litigation*, 94 F. Supp. 2d 652 (D. Md. 2000), for the proposition that "bare allegations that [respondents] 'knew but concealed' or 'knew or were reckless in not knowing' certain material information" was "insufficient to plead scienter." But unlike this case, *Shields and Criimi Mae*, respectively, dealt with plaintiffs who failed to support allegations of scienter with the specificity and sufficiency required by the Federal Rules of Civil Procedure or the Private Securities Litigation Reform Act of 1995 ("PSLRA"). *Shields*, 25 F.3d at 1128-1130 (finding that plaintiffs failed to plead scienter with particularity, where defendants, an issuer and two of its senior executives, made positive predictions about their company's future that were incorrect only when held up "against the backdrop of what actually transpired"); *Criimi Mae*, 94 F. Supp. 2d at 661-662 (finding that plaintiffs failed to plead scienter with the required particularity under the PSLRA, where plaintiffs' scienter allegations were based purely on the fact that defendants held positions of control with the issuer). The pleading standards under the Federal Rules or the PSLRA do not apply to our evaluation of the evidence in the record. Moreover, there are sufficient facts here to demonstrate that respondents were aware of the danger of misleading their customers through omissions of their financial self-interests.

Respondents also contend that their trading activity in DEER stock shows that they lacked scienter. In this regard, respondents claim: (1) that they made continuous customer recommendations of DEER, well before the $350,000 payment or joining First Merger; (2) that they sold DEER because it was an active stock, a NASDAQ Global Select listing, and widely followed by Wall Street firms and institutional investors; (3) that, due to a price increase, their customers "liquidated vastly more DEER stock than they purchased," which "proves that the Fee had no material bearing or influence upon Respondents['] interactions with customers"; and (4) that DEER transactions during the relevant period accounted "only" for 11% of First Merger's total commissions and that this was "no pump and dump scheme." At best, respondents have shown that it is not clear what actually motivated them to solicit purchases of DEER stock. On the one hand, respondents highlight market-based reasons, unrelated to the $350,000 payment, why they may have solicited purchases of DEER stock. On the other hand, respondents received and spent the $350,000 from DEER and then *immediately* began soliciting purchases of substantial amounts of DEER stock. Moreover, as Enforcement pointed out at oral argument, because some of respondents' customers wanted to "cash in," DEER may have "needed new buyers to help keep the price up." Regardless, respondents' true motivation is besides the point. By failing to disclose the $350,000 payment and their business relationship with DEER, respondents deprived their customers of the opportunity to evaluate for themselves respondents' competing motivations and the extent to which respondents were soliciting purchases of DEER stock because of their relationship with DEER.

Finally, respondents argue that they lacked scienter because they relied on counsel and supervisors, and that no supervisor, compliance officer, or attorney ever advised them that disclosure of the $350,000 payment was necessary. While respondents had "an independent obligation to comply with the provisions at issue here and cannot shift this responsibility to others,"[36] reliance on legal advice is a "relevant consideration in evaluating a defendant's scienter." *Howard v. SEC*, 376 F.3d 1136, 1147-48 (D.C. Cir. 2004) (holding that reliance on legal advice "is simply evidence of good faith"). Respondents, however, never testified that they sought or obtained advice from a lawyer—or, for that matter, any compliance officer or supervisor—concerning whether they needed to disclose the $350,000 payment or their business relationship with DEER, let alone show that they made full disclosure to a lawyer or set forth the substance any such advice. *See Howard Brett Berger*, Exchange Act Release No. 58950, 2008 SEC LEXIS 3141, at *40 (Nov. 14, 2008) (holding that an advice-of-counsel argument must demonstrate that the respondent made full disclosure to counsel, appropriately sought to obtain relevant legal advice, obtained it, and then reasonably relied on the advice and noting that it "isn't possible to make out an advice-of-counsel claim without producing the actual advice from an actual lawyer") (internal quotation marks omitted), *aff'd*, 347 F. App'x 692 (2d Cir. 2009). Moreover, respondents could not interpret the absence of any advice from their supervisors or compliance officers as an indication they approved of respondents' omission of the $350,000 payment. *Cf. Richard A. Neaton*, Exchange Act Release No. 65598, 2011 SEC LEXIS 3719, at

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[36] *Richard G. Cody*, Exchange Act Release No. 64565, 2011 SEC LEXIS 1862, at *65 (May 27, 2011), *aff'd*, 693 F.3d 251 (1st Cir. 2012).

*22-23 (Oct. 20, 2011) (rejecting respondent's argument that his firm's silence about his Form U4 disclosure obligations excused his failures to disclose).[37]

* * * * *

For the reasons explained above, when soliciting customers to purchase DEER securities, respondents fraudulently omitted to disclose that they were the primary beneficiaries of a $350,000 payment from DEER and had a business relationship with DEER. This conduct was in willful violation of Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, FINRA Rules 2020 and 2010.[38]

B. Outside Business Activities

NASD Rule 3030 provided that "[n]o person associated with a member in any registered capacity shall be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member." The Hearing Panel found that respondents, while registered with Seaboard Securities, failed to disclose outside business activities with DEER to Seaboard Securities, in violation of NASD Rule 3030. We affirm.

Scholander and Harris were engaged in a business activity with DEER outside the scope of their relationship with Seaboard Securities, and they accepted compensation from DEER as a result of that business activity. As noted above, Scholander admitted, in his on-the-record interview that he and Harris performed consulting services for DEER, while they were registered with Seaboard Securities, and that DEER made a $350,000 payment for those consulting services to First Merger Delaware. Specifically, Scholander admitted that he personally provided consulting services to DEER when he was in China, and that he and Harris also provided

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[37] To establish liability under Section 10(b) and Exchange Act Rule 10b-5 also requires proof that respondents used "any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange." 17 C.F.R. § 240.10b-5. Respondents do not dispute that they communicated with customers through telephone calls, thereby satisfying the interstate commerce requirement. *See SEC v. Softpoint, Inc.*, 958 F. Supp. 846, 865 (S.D.N.Y. 1997) (determining that the jurisdictional requirements of the federal antifraud provisions are "broadly construed" and are satisfied by intrastate telephone calls and the use of the U.S. mail), *aff'd*, 159 F.3d 1348 (2d Cir. 1998).

[38] In the proceedings below, Enforcement alleged that respondents' fraud liability "extends to the acts of other brokers . . . that were acting under their direction and control" because respondents "directed others to sell DEER and did not advise them of the DEER payment," and "[a]s a result, those other brokers did not disclose the payment to their customers." The Hearing Panel made no findings, however, concerning whether respondents' fraud violations extended to other First Merger representatives' sales of DEER, and Enforcement has made no arguments on appeal concerning these allegations. As a matter of our discretion, we do not address this issue.

consulting services on conference calls. Scholander also admitted that these services are what were provided to earn the $350,000 fee that DEER paid to First Merger Delaware, and we have already found that that Scholander and Harris, along with Zakai, were the primary beneficiaries of that fee.

While the record suggests that DEER's payment of $350,000 was for something more than the services Scholander admitted providing—advice provided on a few conference calls and during a two-hour visit to DEER's offices—his admissions are enough to demonstrate that he and Harris were involved in a "business activity" with DEER about which they were required to provide prompt, written notice to Seaboard Securities. "[A]n associated person is required to disclose outside business activities at the time when steps are taken to commence a business activity unrelated to his relationship with his firm." *See Dep't of Enforcement v. Schneider*, Complaint No. C10030088, 2005 NASD Discip. LEXIS 6, at *13-14 (NASD NAC Dec. 7, 2005).

Respondents also did not give Seaboard Securities any written notice—prompt or otherwise—about their business activities for DEER, including the possibility of an advisory fee or the $350,000 received from DEER. Scholander claimed that he orally told a compliance person at Seaboard Securities that he was going to China "on a due diligence road show" and "as part of [his] work as a broker at Seaboard" and that Seaboard Securities understood he was gaining "knowledge" about DEER to see "are we going to buy more or less of this company." But these claims provide no defense. Oral notification to compliance staff was insufficient because NASD Rule 3030 required prompt written notice. And even assuming that Scholander's testimony about what he told his compliance staff was truthful, nothing in that notification disclosed that he was engaged in business activity for DEER or that he would be compensated for it. Therefore, respondents engaged in outside business activities violations, in violation of NASD Rule 3030 and NASD Rule 2010.

V. Sanctions

A. Fraudulent Omissions

For Scholander's and Harris' fraudulent omissions of material facts, the Hearing Panel barred respondents from associating with a member firm in any capacity. As explained below, we affirm the bars imposed by the Hearing Panel.

In assessing sanctions, we consider FINRA's Sanction Guidelines ("Guidelines"), including the Principal Considerations in Determining Sanctions set forth therein and any other case-specific factors.[39] For intentional or reckless misrepresentations or material omissions of fact, the Guidelines recommend that adjudicators consider imposing a fine between $10,000 to

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[39] *See FINRA Sanction Guidelines* (2013), http://www.finra.org/web/groups/industry/@ip/@enf/@sg/documents/industry/p011038.pdf [hereinafter "Guidelines"].

$100,000, a suspension in any or all capacities of 10 business days to two years, and, in egregious cases, a bar.[40]

Numerous aggravating factors support the conclusion that respondents' violations warrant sanctions towards the high end of the relevant sanctions range. Between February 2010 and November 2010, respondents sold $961,852.68 of DEER stock to 35 customers, without disclosing material facts.[41] Respondents engaged in numerous acts of fraud over an extended period of time.[42] Respondents' omissions were at least reckless.[43] In addition, respondents' fraudulent omissions resulted not only in the potential for their monetary gain, but actual gain.[44] Respondents generated $13,700 in gross commissions from their sales of DEER stock between February 2010 and November 2010.

Another aggravating factor is that Scholander and Harris attempted to provide inaccurate or misleading testimony or documentary information to FINRA during its investigation.[45] During FINRA's investigation, Scholander provided an inaccurate affidavit in which he purportedly sought to "clarify and correct" statements he provided during his on-the-record interview concerning the $350,000 payment. Scholander also falsely testified at an on-the-record interview in July 2010 that he traveled to China with Gearty three or four months before the on-the-record interview when employed by First Merger. In fact, Scholander traveled to China eight months earlier when he was employed by Seaboard Securities. Scholander's false testimony on this point was, as the Hearing Panel found, likely intentional, considering that there was no reasonable explanation for how he could have been confused about the timing of such a recent trip and that he had a motivation to conceal the truth from regulators. As for Harris, he falsely testified at a July 2010 on-the-record interview that he had not put any money into First Merger or RRZ Management to fund First Merger. In fact, he had done so just four months earlier. Respondents' untruthfulness reflects strongly on their fitness to serve in the securities industry. *See Burch*, 2011 FINRA Discip. LEXIS 16, at *47.

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40 *Id.* at 88.

41 *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 18) (directing adjudicators to consider "[t]he number, size and character of the transactions at issue).

42 *Id.* at 6 (Principal Considerations in Determining Sanctions, Nos. 8, 9).

43 *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 13).

44 *Id.* (Principal Considerations in Determining Sanctions, No. 17).

45 *Id.* (Principal Considerations in Determining Sanctions, No. 12). Respondents argue that these issues have "nothing to do with the conduct" at issue. But the Guidelines make clear that an attempt to provide inaccurate or misleading testimony or documentary information in an investigation is relevant to a sanctions determination.

Respondents fail to demonstrate any mitigating factors. Respondents argue that they have no prior adverse disciplinary actions or customer litigation. Such factors, however, are not mitigating "because an associated person should not be rewarded for acting in accordance with his duties as a securities professional." *Kent M. Houston*, Exchange Act Release No. 71589, 2014 SEC LEXIS 614, at *30 (Feb. 20, 2014).

Respondents contend that no supervisors, lawyers, or compliance officers expressed any opinion that the fee had to be disclosed. But while it is true that a respondent's demonstration of reasonable reliance on competent legal advice is a relevant consideration for purposes of sanctions,[46] respondents offered, as mentioned above, no evidence showing that they reasonably relied on competent legal advice, let alone asked for such advice. And if respondents' attempts to blame others show anything, it is that respondents have not accepted responsibility for their violations.[47] *See Castle Sec. Corp.*, 58 S.E.C. 826, 834 (2005) (considering blame-shifting arguments as relevant to sanctions determination).

Respondents assert that their customers were sophisticated and thus in no need of disclosure, but they provided no evidence in support of that self-serving contention.[48] In any event, "the protection of the antifraud provisions of the securities laws extends to sophisticated investors as well as those less sophisticated." *Dolphin and Bradbury, Inc.*, 2006 SEC LEXIS 1592, at *36; *see also* SEC Press Release No. 2010-123 (July 15, 2010) (noting that the settlement of *SEC v. Goldman Sachs*, http://www.sec.gov/news/press/2010/2010-123.htm, which involved the alleged misleading of investors in a subprime mortgage product, is "a stark lesson . . . that no product is too complex, and no investor too sophisticated, to avoid a heavy price if a firm violates the fundamental principles of honest treatment and fair dealing"). Indeed, even a sophisticated investor would have had no way of knowing, absent respondents' disclosure, of the $350,000 payment.

Finally, respondents argue that the sanctions imposed in settled cases with other First Merger employees were lower. However, "the appropriateness of the sanctions imposed depends on the facts and circumstances of the particular case and cannot be determined precisely by comparison with action taken in other cases." *Dennis S. Kaminski*, Exchange Act Release No. 65347, 2011 SEC LEXIS 3225, at *41 (Sept. 16, 2011). Moreover, "comparisons to sanctions in settled cases are inappropriate because pragmatic considerations justify the acceptance of lesser sanctions in negotiating a settlement such as the avoidance of time-and-manpower-consuming adversary proceedings." *Houston*, 2014 SEC LEXIS 614, at *33 (internal quotation marks omitted).

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46 *Guidelines*, at 6 (Principal Considerations in Determining Sanctions, No. 7).

47 *Id.* at 6 (Principal Considerations in Determining Sanctions, No. 2).

48 *Guidelines*, at 7 (Principal Considerations in Determining Sanctions, No. 19). A FINRA investigator testified that the customers "appeared to be somewhat high net worth or medium net worth individuals." For purposes of the Guidelines, however, the amount of a customer's net worth does not provide information about that customer's level of sophistication.

Considering the nature of respondents' fraudulent omissions, the aggravating factors that are present, and the absence of mitigation, respondents' violations warrant sanctions at the high end of the relevant sanctions range. Respondents violated their duty, of vital importance to the functioning of the securities markets, to provide their customers with full disclosure of their business relationships with issuers of the securities they recommended. For these reasons, we bar both Scholander and Harris from associating with any member firm in any capacity. Such sanctions are appropriate to remedy respondents' violations, protect investors, and deter others from engaging in similar misconduct.

B. Outside Business Activities

The Hearing Panel indicated that for respondents' outside business activities violations, a $10,000 fine on each respondent would have been appropriate. Stronger sanctions, however, are warranted to remedy these violations.

For outside business activities violations, the Guidelines recommend imposing a fine between $2,500 and $50,000 and indicate that the recommended fine may be increased by adding the amount of a respondent's financial benefit.[49] The Guidelines further recommend that adjudicators consider imposing a suspension up to 30 days when the outside business activities do not involve aggravating conduct, a longer suspension of up to one year when there is aggravating conduct, and a longer suspension or a bar in egregious cases, including those involving a substantial volume of activity or significant injury to customers.[50]

Respondents' outside business activities violations were not egregious, and it is difficult to assess the extent and duration of respondents' outside activities. Nonetheless, there are several aggravating factors. Respondents' outside activities involved a customer of Seaboard Securities (DEER) and resulted in the potential for respondents' gain.[51] In addition, Scholander's inaccurate on-the-record testimony about the timing of his China trip appears to have been an effort to conceal his outside activities from a regulator.[52]

Considering these facts and circumstances, a three-month suspension and a $15,000 fine, imposed on each respondent, is sufficient to remedy respondents' outside business activities violations. We do not impose such sanctions, however, in light of the bars imposed for respondents' fraud.

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49 *Guidelines*, at 13.

50 *Id.*

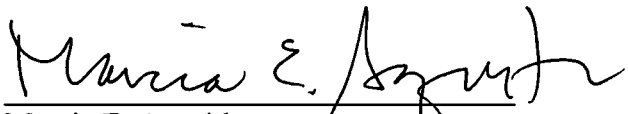
51 *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 17), 13 (Principal Considerations in Determining Sanctions, Nos. 1, 3).

52 *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 12).

VI. Conclusion

Accordingly, we affirm the Hearing Panel's findings that Scholander and Harris made fraudulent omissions of material fact in willful violation of Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, and FINRA Rules 2020 and 2010,[53] and failed to provide written notice to their employer about their outside business activities, in violation of NASD Rule 3030 and FINRA Rule 2010. For their fraudulent omissions, Scholander and Harris are barred from associating with any member firm in any capacity. No additional sanctions are imposed for respondents' outside business activities violations. We affirm the Hearing Panel's order that respondents pay $7,089.79 in hearing costs and that each respondent pay one-half of these costs (i.e., $3,904.89). Finally, we impose on each respondent appeal costs of $1,319.04. The bars are effective upon service of this decision.

On Behalf of the National Adjudicatory Counsel,



Marcia E. Asquith,
Senior Vice President and Corporate Secretary

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[53] Scholander's and Harris' willful violation of Section 10(b) of the Exchange Act gives rise to a statutory disqualification. *See* Sections 3(a)(39)(F) and 15(b)(4)(D) of the Exchange Act.