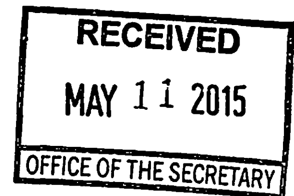
BEFORE THE

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C.



In the Matter of the Application of

William Scholander

and

Talman Harris

For Review of

FINRA Disciplinary Action

File No. 3-16360

FINRA'S BRIEF IN OPPOSITION TO APPLICATION FOR REVIEW

Alan Lawhead
Vice President and
Director – Appellate Group

Michael Garawski
Associate General Counsel

FINRA
1735 K Street, NW
Washington, DC 20006
(202) 728-8835

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FINRA'S BRIEF IN OPPOSITION TO APPLICATION FOR REVIEW

I. INTRODUCTION

This case is about the months-long failure of William Scholander ("Scholander") and Talman Harris ("Harris") to disclose material conflicts of interest related to a $350,000 payment from, and their ongoing business relationship with, Deer Consumer Products, Inc. ("DEER"), when soliciting dozens of investors to purchase nearly $1 million of DEER securities.[1] It is also about Scholander's and Harris' failure to provide required notice of their outside business activities with DEER to their employing broker-dealer.

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[1] References to the certified record are cited as "RP _____." References to applicants' opening brief are cited as "Br. ___."

In December 2009, Scholander and Harris were among the primary recipients of a $350,000 payment from DEER. They immediately used that payment in furtherance of a joint plan to acquire a broker-dealer named First Merger Capital, Inc. ("First Merger") and open a branch office of that firm. Immediately after opening their new branch office built with DEER's payment, Scholander and Harris began selling DEER securities from that office. They would sell DEER securities for months, to numerous customers, and in large amounts: between February 2010 and November 2010, Scholander, Harris, or both were listed as representatives on 35 customer accounts that purchased nearly $1 million in DEER securities. Over the same time period, Scholander's and Harris' new branch office sold nearly $3 million in DEER securities to 132 customers, generating commissions that amounted to 11% of First Merger's gross revenues. When selling DEER securities to their customers, however, Scholander and Harris did not disclose their recent receipt from DEER of the $350,000, or the ongoing business relationship with DEER to provide unspecified advisory services for the $350,000 payment.

Other circumstances brought Scholander's and Harris' conflict of interest when selling DEER securities into even more stark relief. DEER was not just Scholander's and Harris' current business client. Rather, they had recently handled two private placement deals for DEER and recently attempted to land similar investment banking business from DEER. Moreover, in the years leading up to the relevant period, Scholander and Harris offered and sold the stock of DEER and other China-based companies that had relationships with their longstanding business associates Benjamin Wey ("Wey") and Robert Newman ("Newman"), both of whom were involved in facilitating Scholander's and Harris' plans to acquire First Merger as well as the outside business activities that generated the $350,000 payment.

Reasonable investors, when being solicited by Scholander and Harris to purchase DEER securities, would have wanted know about these facts to evaluate Scholander's and Harris' objectivity. They would have wanted to explore whether Scholander's and Harris' motivations for recommending DEER was because of their business relationships with DEER, Wey, and Newman, instead of the investors' interests. But Scholander's and Harris' customers were never given that chance, because Scholander and Harris never disclosed their material conflicts of interest. Moreover, when Scholander and Harris were engaged in providing advisory services to DEER for a fee, they never informed their employing broker-dealer at the time of those activities, either in writing or otherwise.

Based on this evidence, FINRA's National Adjudicatory Council ("NAC") properly found that Scholander and Harris fraudulently omitted to disclose their conflicts of interest when selling DEER securities, and failed to notify their employing broker-dealer of their outside business activities with DEER as required by FINRA rules. For their fraudulent conduct, the NAC barred both Scholander and Harris, sanctions that were based on a thorough review of the facts, deference to the Hearing Panel's credibility determinations, the relevant law and legal precedents, and numerous aggravating factors. Such aggravation included Scholander's and Harris' $961,852 in fraudulent sales, their numerous fraudulent solicitations over a period of months, their monetary gain, and their attempts to provide inaccurate or misleading information to FINRA staff investigating their misconduct. The NAC's findings are well-supported by the evidentiary record, and its sanctions were an appropriate remedy to protect the investing public.

Scholander and Harris point to nothing that shows otherwise. Their argument why they had no duty to disclose their conflicts—newly tweaked since their unsuccessful motion to stay—is that registered representatives only have to disclose conflicts that have a narrowly defined

"nexus to the transaction." But it is black-letter law that a registered representative has a duty to disclose material facts to customers when soliciting them to purchase securities, and that what is "material" is information that reasonable investors would likely find important in deciding whether to invest. Applicants identify no cases articulating their more severely cramped standard of disclosure and make no argument that their conflicts were not important information to reasonable investors. Likewise, applicants' challenges to the bars ignore numerous aggravating factors and point to nothing that qualifies as mitigation. The Commission should sustain the NAC's findings and sanctions because they are well-supported by the record and the egregious nature of applicants' fraud, and because bars are an appropriate sanction to protect investors from future harm at applicants' hands.

II. FACTUAL BACKGROUND

A. Scholander's and Harris' Employment History, Their Past Work for DEER, and Their Connections to Benjamin Wey and Robert Newman

While applicants "assume the NAC's findings are true" for purposes of their brief (Br. 1), their limited description of the background barely scratches the surface of the relevant facts. The story of Scholander's and Harris' material conflicts of interest begins with a review of their securities industry experience, including their prior business dealings with DEER and their longstanding business ties to the promoters of DEER's securities.

Since entering the securities industry in the mid-to-late 1990s, Scholander associated with 13 firms, and Harris associated or registered with 16 firms. RP 511-520, 647-651, 1739-1745, 1767-1776. Beginning in 2002, they operated as partners, and beginning in 2007 they co-owned several branch offices. RP 512, 515, 518-19, 650-651. Scholander and Harris started receiving an override on all the business that was done at the branch offices, and that stayed the same at

later firms they joined. RP 522. During the relevant period—roughly fall 2009 through 2010—Scholander and Harris were registered with two firms. Specifically, from spring 2009 through February 2010, applicants were registered with Seaboard Securities, Inc. ("Seaboard Securities") as general securities representatives. RP 1740-1741, 1769. From February 2010 to March 2011, applicants were registered with First Merger, as general securities representatives and investment banking limited representatives.[2] RP 1740, 1768.

Prior to the relevant period, Scholander and Harris provided investment banking services to DEER, a designer and manufacturer of home and kitchen electric appliances and a Nevada corporation that has its principal offices in China. RP 1486, 1489. They sold two parts of a DEER private placement, the first part in 2008 when they were registered with Martinez-Ayme Securities, and the second part while later registered with Seaboard Securities. RP 530, 537-540, 1255-1258, 1268. Scholander testified that his compensation for selling DEER stock through the private placements was "10 percent cash and 10 percent warrants."[3] RP 538, 540; *see also* RP 1848. Scholander and Harris obtained the DEER private placement deals—and similar deals with other Chinese companies—through their longstanding, close business

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[2] Towards the end of his association with First Merger, Harris also was registered as a general securities principal. RP 1768. Most recently, Scholander and Harris were registered with Radnor Research & Trading Company, LLC ("Radnor Research"). RP 1739-40, 1767-68. That registration terminated on January 20, 2015, a few weeks after the NAC's decision. *See* Central Registration Depository ("CRD®"); RP 511-512, 645.

[3] Harris testified that DEER "was a reverse merger that did a private placement through my firm." RP 1296. Scholander testified that, in addition to the private placement deals, at some point he also sold DEER securities to investors in open market purchases and recommended that other brokers in his office also sell DEER securities to their customers. RP 540.

relationship with Wey, Wey's firm New York Global Group, and Newman.[4] RP 10 (¶17), 31 (¶17), 516, 517, 520-524, 530-538, 652-655, 1208, 1701, 1731. Wey—once an officer of a broker-dealer—was the co-founder and president of New York Global Group, which was a "middle market advisory firm on Wall Street specialized in executing Chinese related transactions" and a "source of . . . deal flow for investment banks and institutional investors worldwide," and he introduced Chinese companies to the U.S. markets. RP 530, 653, 1707-1709, 1711, 1713. One of the companies for which Wey and New York Global Group provided services was DEER. RP 9 (¶13), 30 (¶13).

Wey and Newman, the issuing companies' attorney and Wey's friend, would facilitate the private placement deals referred to Scholander and Harris by introducing them to the issuing companies, bringing representatives of the issuers to Scholander's and Harris' offices, and arranging for Scholander, Harris, and their colleagues to visit the issuers in China.[5] RP 530-538, 654-655, 971-972, 1289, 1346-1348, 1823-1827. Newman also would refer to Scholander and Harris the employees of the issuers whom Scholander and Harris were recommending in secondary markets. RP 636. Offering a window into how important his business relationship with Newman was, Scholander testified that he once told Newman, "If you're working with

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4 Scholander and Harris met Wey in 2002 when they all worked for the same broker-dealer, Benchmark Securities Group, Inc., of which Wey was the CEO. RP 516, 529, 652, 1699. Subsequently, Scholander and Harris worked for a broker-dealer (New York Global Securities, Inc.) that was owned by Wey's company New York Global Group; worked in the same office suite at 14 Wall Street with New York Global Group; leased that same office space from New York Global Group for years; and were referred to Seaboard Securities by Wey. RP 516, 520-524, 529, 530, 531, 652-654, 1701, 1731.

5 In an on-the-record interview, the former branch manager of Scholander's and Harris' Seaboard Securities branch office described Wey's influence this way: "[I]t was just too much Ben [Wey]. You know, . . . he has the space, he's got the securities, he's got the firm . . . ." RP 1820-1821.

anything else [i.e., any private placement deals] I will definitely be interested. Whatever firm I'm at, I will present it to the owners, and if they're interested, if they approve the deal, I'm aboard." RP 632.

B. With Wey's and Newman's Involvement, Scholander, Harris, and Ronen Zakai Jointly Plan to Acquire a Broker-Dealer

Around fall 2009, Wey referred Scholander and Harris to Ronen Zakai ("Zakai"). RP 541, 915, 916. At Newman's suggestion, Scholander, Harris, and Zakai—a broker who also had business ties to Wey and DEER—jointly planned to acquire a broker-dealer. RP 541-542, 544, 667, 915-917, 1568, 1867, 1869-1874, 2591-2594, 2595-2596, 2599-2603, 2611. Under their plan, Scholander, Harris, and Zakai each would contribute approximately $100,000 towards the acquisition, and each would own 33% of the acquired broker-dealer. RP 1553-1554, 1564-1565, 1872-1875, 3248-3249. Maureen Gearty ("Gearty"), an operations manager with whom Zakai had worked, was to receive a 1% stake in the acquired firm. RP 542, 911-913, 921-923, 1553-1554, 1564-1565, 1872-1875, 3181, 3248-3249. Gearty would work in support of the acquisition efforts but did not have to contribute any financing. RP 922-923, 1875.

The purchasing group made significant progress towards their acquisition plan. This included identifying Brentworth and Company, Inc. ("Brentworth") as the acquisition target; retaining a firm (ACI) to assist with applying to FINRA to change the firm's ownership; meeting with Brentworth's owner (Mark Simonetti); deciding what Gearty's salary would be; entering into an agreement to purchase Brentworth for $85,000; paying Brentworth's owner; changing the firm's name to "First Merger, Inc."; signing a branch agreement; and hiring a chief compliance officer. RP 12 (¶34), 32 (¶34), 667-668, 931-935, 938-939, 1006, 1021, 1114, 1553, 1557, 1566, 1609-1610, 2640, 3181. Scholander paid $65,000 of the purchase price through an entity he

formed named Infinite Dragon. RP 923, 1174-1179, 1223-1224, 1226-1227, 1905, 2013, 2015, 3239. Wey—whom Gearty described was "the mastermind behind this whole thing"—and Newman were both involved in developing the acquisition plans, either by proposing the joint acquisition in the first place or discussing with the purchasing group the logistics of facilitating the acquisition. RP 544, 915, 919, 921-924, 927.

C. Scholander and Harris Provide a Limited Amount of Advisory Services to DEER for a $350,000 Fee

At the same time these plans to acquire First Merger were progressing, Scholander's and Harris' business relationship with Wey and Newman yielded even more work for DEER that generated a $350,000 fee. In early November 2009, Wey facilitated a trip by Scholander and Gearty to visit DEER's offices in China. RP 943-947. Scholander and Gearty visited DEER's offices for only two hours and toured a DEER display at a shopping mall. RP 569, 951-957. During their visit, "one guy from Wey's office" was present. RP 954. Scholander and Gearty introduced themselves to DEER as representatives of "the broker dealer" (i.e., First Merger/Brentworth). RP 955, 956. Scholander admitted that while in China, he performed consulting work for DEER for an "advisory fee." RP 558-559, 562-563. Scholander explained that "[w]e . . . discussed [with DEER] . . . how they're going to grow," and that he offered his positive opinion on an investment bank (Bank of Montreal) that DEER had retained. RP 558-559. Scholander also discussed with DEER "their products," including his advice "to put them in different stores" and about "how I would sell their product." RP 563. Scholander further explained that the "advisory fee" also was earned through advice that he and Harris, among others, provided on a conference call with Newman concerning "our opinions in [DEER] and what they can do to improve and appeal to the investors." RP 558-559. Scholander and Harris

never notified their employing firm at the time, Seaboard Securities, of their outside business activities with DEER. RP 685, 1238-1239, 1850-1851.

D. Scholander, Harris, and Zakai Receive, and Direct the Spending of, the $350,000 Fee Towards the Broker-Dealer Acquisition Plan

The $350,000 fee, an outsized amount for the few hours of advisory services that were provided—or as Gearty more succinctly put it, "the easiest [money] ever"—was received on December 17, 2009, in a bank account owned by a company also named First Merger ("First Merger Delaware"). RP 958. Gearty had formed First Merger Delaware specifically to receive the $350,000 fee, but, as she credibly testified, the money belonged to Scholander, Harris, and Zakai.[6] RP 847, 958, 963, 967-970, 974-975, 1073, 1475. Scholander and Newman were involved in facilitating the transfer of the $350,000 from DEER. RP 970.

In less than two months from when the $350,000 was received, Scholander, Harris, and Zakai spent it in furtherance of their joint plan to acquire First Merger, which included opening a new First Merger branch office on Wall Street. *See generally* RP 960-963, 977-1001. They used it to pay the firm that was facilitating the attempted acquisition (ACI), that firm's lawyer (Richard Nummi, Esq.), a graphic designer, a communications company, a real estate broker, and a receptionist whom Wey directed them to hire. They spent it on things like a deposit with their clearing firm, pre-payment of rent, Gearty's compensation, sign-on bonuses for new brokers, office construction, and Chinese office furniture. *See generally* RP 929-930, 977-1001, 1469-1479, 1565, 1568. They also used it to reimburse Harris for Manhattan gym club memberships

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[6] Gearty explained that Scholander and Harris could not directly accept the $350,000 because they were still registered with Seaboard Securities, and that their instruction to her with regard to obtaining the fee was "[j]ust get it done." RP 972-973.

he had purchased for Scholander, Zakai, Wey, and himself, and to reimburse Scholander for expenses he incurred on his trip to DEER's offices. RP 982-983, 999-1000, 1095, 1359, 1472, 1474. Gearty reported about her progress on opening the branch office to Scholander and Harris every single day. RP 940-941, 969. Likewise, while working on these tasks in the Seaboard Securities/New York Global Group office suite, Gearty would see Wey "every day," who would ask Gearty about her work in support of the acquisition plan. RP 942-943. The $350,000 was fully spent by February 4, 2010. RP 1001, 1003-1004, 1472.

At the same time, progress continued on other tasks related to the joint plan to acquire First Merger. A branch agreement was signed. RP 1021, 1114, 1609-1610, 3230. Harris, through an entity he formed, contributed $32,500 towards the acquisition. RP 668-669, 1302, 1297-1302, 2017. And business cards were drafted for Scholander, Harris, and Zakai indicating that each would be a managing partner at First Merger. RP 1584, 1587-1588.

E. The New First Merger Branch Office Opens, Scholander and Harris Register with First Merger, and They Immediately Begin Selling DEER Securities

In early February 2010, the new First Merger branch office opened on Wall Street. RP 526, 571-572. On February 9, 2010, Scholander and Harris terminated their association with Seaboard Securities, and within days they were registered with First Merger and began working in the new branch office built with DEER's payment. RP 571, 1300, 1740-1741, 1768-1769. Scholander and Harris brought with them to First Merger many of the representatives with whom they worked at Seaboard Securities. RP 526-527, 571-573. Around the same time, Wey's company, New York Global Group, moved its offices to the same building. RP 526. Gearty testified that $172,000 in payments from First Merger to Scholander and Harris was to be used to pay for Wey's move to 40 Wall Street. RP 1030, 1639.

Right out of the gate—and for months thereafter—Scholander's and Harris' new First Merger branch office began selling to customers substantial amounts of securities issued by companies that had ties to Wey and Newman, including DEER.[7] RP 530, 576, 765-768, 1459. The sales of DEER alone were substantial. In February and March 2010, between 72% and 75% of all customer purchases of First Merger securities were purchases of DEER. RP 1465. From February 2010 through November 2010, a total of 132 First Merger customers purchased $2,942,299 in DEER securities, and 11% of First Merger's gross revenues were generated from purchases and sales of DEER securities. RP 788-789, 794-796, 1459, 1463, 1465. Scholander, Harris, or both, were listed as representatives on 35 customer accounts that purchased $961,852.68 in DEER securities. RP 574, 691, 769-772, 774, 1208, 1461. These purchases generated $13,700 in gross commissionss. RP 574, 691-692, 1195, 1461. Wey, Newman, and DEER management visited the new First Merger branch office a few months after sales of DEER securities commenced. RP 534, 2411-2412, 2698-2699. Wey had "unfettered access" to the First Merger offices.[8] RP 1031, 1032.

Scholander and Harris admitted that, when they solicited purchases of DEER securities, they did not disclose to their customers the $350,000 payment from DEER. RP 574, 692.[9]

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[7] Gearty testified that Harris would conduct staff meetings "getting everyone psyched up about First Merger and, you know, different companies, DEER." RP 1009.

[8] Newman also had discussions with First Merger's attorneys about the ownership structure of First Merger and its application to change ownership. RP 1899-1901.

[9] Scholander's and Harris' relationship with Wey and Newman also led to other significant revenues in the early days of the First Merger branch office. Newman referred four employees of a Chinese company named SmartHeat to sell their restricted stock through Scholander's and Harris' branch—or, as Scholander gushed, "sell side business" that "every brokerage firm wants." RP 14 (¶46), 33 (¶46), 582-585, 631, 693-698, 1013-1019. These four accounts came to First Merger within two weeks of the First Merger branch office opening. RP 1015. The sales of

[Footnote continued on next page]

III. PROCEDURAL HISTORY

FINRA commenced the investigation that led to this proceeding after receiving an anonymous tip that Wey controlled Scholander's and Harris' Seaboard Securities branch office and that Seaboard Securities branch office personnel were being pressured to sell stocks of companies with ties to Wey. RP 897. FINRA's Department of Enforcement filed the complaint that initiated this proceeding on January 31, 2012. RP 1-25. On August 16, 2013, a FINRA Hearing Panel issued a decision finding, in relevant part, that applicants engaged in fraudulent omissions when selling DEER securities in violation of Section 10(b) of the Exchange Act, Rule 10b-5 thereunder, and FINRA Rules 2020 and 2010, and failed to disclose their outside business activities to their firm, in violation of NASD Rules 3030 and FINRA Rule 2010. The Hearing Panel barred applicants in all capacities for their fraud and required each of them to pay $3,904.89 in hearing costs. RP 2805-2850. The Hearing Panel indicated a $10,000 fine would have been appropriate for applicants' outside business activities violations but did not impose that fine in light of the bars imposed. RP 2848-2849.

On December 29, 2014, the NAC affirmed the findings, the bars, and the costs, and it imposed on each applicant $1,319.04 in appeal costs. RP 3379-3414. The bars became effective upon issuance of the NAC's decision. RP 3414. The NAC also noted that Scholander's and Harris' willful violation of the Exchange Act gave rise to their statutory disqualification. RP 3414. The NAC did not impose separate sanctions for Scholander's and Harris' failure to provide notice to Seaboard Securities of their outside business activities, but stated that stronger

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[cont'd]

these employees' shares of SmartHeat generated more than $1.3 million in commissions for the First Merger branch office. RP 585, 742-743, 766, 1459, 1605.

sanctions than what the Hearing Panel would have imposed would be warranted. RP 3413. The NAC indicated that a three-month suspension and a $15,000 fine, imposed on each respondent, would have been appropriate. RP 3413.

This appeal followed. On March 10, 2015, the SEC denied Scholander's and Harris' request to stay the bars while this appeal is pending. The SEC found, among things, that applicants did not meet their burden of "showing . . . a likelihood that they will succeed on the merits of their appeal." *William Scholander*, Exchange Act Release No. 74437, 2015 SEC LEXIS 841, at *22 (Mar. 4, 2015).

IV. ARGUMENT

The evidentiary record amply supports the NAC's findings that Scholander and Harris fraudulently omitted their material conflicts of interest when selling DEER securities, and that they failed to give their employing broker-dealer notice of their outside business activities with DEER as required by FINRA's rules. Given the egregiousness of applicants' fraudulent conduct, the numerous aggravating factors, and the absence of any mitigation, the bars imposed by the NAC for their fraudulent conduct are fully warranted to protect the public from future harm at their hands. Likewise, three-month suspensions and $15,000 fines would be appropriate sanctions to impose for applicants' violation of FINRA's outside business activities rule and will deter others from engaging in similar violations. The Commission should affirm the NAC's decision in all respects.

A. Scholander and Harris Engaged in Fraudulent Solicitations of DEER Securities.

Section 10(b) of the Exchange Act and Exchange Act Rule 10b-5 prohibit fraudulent and deceptive acts and practices in connection with the offer, purchase, or sale of a security. *Alvin*

W. Gebhart, Exchange Act Release No. 58951, 2008 SEC LEXIS 3142, at *22-23 (Nov. 14, 2008), *aff'd*, 595 F.3d 1034 (9th Cir. 2010). Among Congress' purposes in passing the Exchange Act was 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 industry." *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972) (also stating that securities legislation enacted for the purpose of avoiding frauds should be "construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes"). To establish liability for fraudulent omissions under Section 10(b) of the Exchange Act and Rule 10b-5 requires proof that Scholander and Harris: (1) made a material omission when they had a duty to speak; (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).[10] The record fully supports each element of liability here.

1. The NAC Correctly Found that Scholander and Harris Omitted Material Facts Concerning Their Conflicts of Interest, in Connection with the Purchase or Sale of Securities, When Soliciting Purchases of DEER Securities.

a. The Record Supports the NAC's Findings.

It is axiomatic that a registered representative has a duty to his customers 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 *23-24 (FINRA NAC July 28, 2011) (citing, *inter alia*, *De Kwiatkowski v. Bear, Stearns & Co.*, 306

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[10] Such a showing also is sufficient to demonstrate violations of FINRA Rules 2020 and 2010. *See Gebhart*, 2008 SEC LEXIS 3142, at *22-23.

F.3d 1293, 1302 (2d Cir. 2002) ("[T]he broker owes duties of diligence and competence in executing the client's trade orders, and 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.")).[11] Whether information is material "depends on the significance the reasonable investor would place on the withheld or misrepresented information." *Basic Inc. v. Levinson*, 485 U.S. 224, 240 (1988). Information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding how to invest his money in a particular security and "the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Id.* at 231-32 (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)); *see also Kevin D. Kunz*, 55 S.E.C. 551, 561-62 (2002), *aff'd*, 64 F. App'x 659 (10th Cir. 2003). The question of materiality is an "objective one." *Kunz*, 55 S.E.C. at 561.

Among the kinds of information that have been deemed to be material—and required to be disclosed by registered representatives when selling securities—are "material adverse facts" including "any self-interest that could influence the salesman's recommendation." *Richard H. Morrow*, 53 S.E.C. 772, 781-84 (1998). The reason why is obvious. A registered

[11] In addition, Scholander and Harris had the duty to provide material information to their customers about their conflicts because they solicited purchases of DEER securities and needed to state all material facts to ensure that their statements about DEER securities were not misleading. *See* 17 C.F.R. § 240.10b-5(b) (providing that it is unlawful "to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading"); *Gebhart*, 2008 SEC LEXIS 3142, at *23-24 (holding that the Gebharts omitted to state facts necessary to make other statements they made not misleading in connection with their offer and sale of notes).

representative's disclosure of his self-interests ensures that his customers have "the opportunity to question whether [their representative] ha[s] a genuine, objective belief that the investment . . . [is] in their best interest before effecting their transactions." *Burch*, 2011 FINRA Discip. LEXIS 16, at *31 (citing *Gilbert A. Zwetsch*, 50 S.E.C. 816, 819 (1991)).

Scholander and Harris had material conflicts of interest when they recommended DEER securities, as shown by numerous circumstances. Applicants' plans to acquire their own broker-dealer and start their own branch office—from which they would later sell large amounts of DEER securities—was financed with a $350,000 payment from DEER. In addition, Scholander and Harris had an ongoing business relationship with DEER to provide unspecified "advisory services" while they were selling DEER securities. In this regard, at the time Scholander and Harris were selling DEER securities, the only "advisory services" they had provided in exchange for the $350,000 payment were opinions provided on a conference call and advice offered during a two-hour visit to DEER's China offices. During that visit, Scholander gave his advice on, among other things, how DEER could sell its kitchen appliances. As the NAC found, "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 that DEER expected for its money." RP 3400-3401. By itself, the $350,000 payment and the ongoing relationship with DEER would be enough to raise reasonable investors' concerns about Scholander's and Harris' objectivity when recommending DEER securities.

Yet there were more undisclosed conflicts. For Scholander and Harris, DEER was not just any issuer but a proven source of business revenues, and applicants were interested in doing more business with DEER. Not only had Scholander and Harris received the $350,000 payment from DEER, they had recently handled two parts of a private placement for DEER—including

one part handled during their recent tenure with Seaboard Securities. Moreover, Scholander and Harris had attempted a few months before the sales at issue to secure a contract with DEER to provide advisory services with a follow-on offering. RP 964-966, 1467-1468. Indeed, Scholander hinted at the possibility of doing more business for DEER. When asked whether it was anticipated that First Merger would provide services to DEER in the future, he testified, "[i]f they contact us." RP 3266.

And that was still not all. Scholander's and Harris' business relationship with DEER was rooted in their longstanding, lucrative business ties to Wey and Newman. Wey was in the business of introducing Chinese companies to the U.S. markets, and Newman was the attorney for several of those issuers. In the years leading up to the sales of DEER securities at issue, Wey and Newman introduced Scholander and Harris to a steady stream of Chinese companies, and Scholander and Harris in turn sold those companies' securities. One of those companies was DEER. Despite applicants' attempt to brush aside these ties, Wey and Newman were directly involved in the events that led to Scholander's and Harris' attempt to acquire a broker-dealer, the receipt of the $350,000, and the sales of DEER securities, and were closely tied to the new First Merger branch office.

These facts and circumstances gave rise to potential conflicts that were numerous and obvious. Reasonable investors would have wanted to evaluate whether Scholander and Harris were selling DEER securities because DEER gave them $350,000 to do so, because it might help secure additional future business with DEER, or because Wey and Newman—who had ties to DEER and who were involved in facilitating the acquisition plan and the arrangement that led to the $350,000—wanted them to do so. The NAC summarized the importance of the undisclosed information:

> 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.

RP 3403.

b. The NAC's Findings that Applicants Omitted Material Facts Are Supported by Precedent and Other Legal Authorities.

The NAC's finding that applicants fraudulently omitted material facts is supported by prior cases that require the disclosure of material conflicts of interest. In *Kevin D. Kunz*, the Commission held that facts such as a "consulting relationship" between the broker and the issuer, "consulting fees paid to [the broker] by [the issuer], and [the issuer's] financing of" a broker-dealer that the broker formed are relationships that would be "material to any prospective investor" because "[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." *Kunz*, 55 S.E.C. at 565. *See also RichMark Capital Corp.*, 57 S.E.C. 1, 9-11 (2003) (holding broker failed to disclose to customers its financial motive to increase the price of securities that it owned or expected to own pursuant to an investment banking agreement with the issuer and that disclosure was needed so "investors could make an informed judgment"), *aff'd*, 86 F. App'x 744 (5th Cir. 2004); *Derek L. DuBois*, 56 S.E.C. 829, 835-837 (2003) (holding that compensation paid by a third-party promoter to a broker to sell securities was material information); *Morrow*, 53 S.E.C at 783-784 (holding that "it would be material for a prospective investor to know that a salesman recommending a particular limited partnership was being compensated by that partnership's general partner and thus that the salesman's recommendation

might not be wholly disinterested"); *Burch*, 2011 FINRA Discip. LEXIS 16, at *30-31 (finding that respondent was required to disclose to customers that his wife was selling the same stock he was recommending); *Dep't of Mkt. Regulation v. Jaloza*, Complaint No. 2005000127502, 2009 FINRA Discip. LEXIS 6, at *20 (FINRA NAC July 28, 2009) (holding that "member firm's interest in promoting a stock," which was linked to its potential consulting relationship with the issuer, the potential for the member firm to receive options in the issuer's securities, the member firm's position in the stock, and its intent to make a market in the securities, had a "potential effect . . . on [broker's] objectivity" that was material to a reasonable investor); *Dep't of Mkt. Regulation v. Respondent*, Complaint No. 2005000191701, 2008 FINRA Discip. LEXIS 15, at *20-23 (FINRA Hearing Panel Apr. 30, 2008) (holding that issuer's provision of stock to broker for no charge, where there was no evidence that respondent's firm "ever provided any services to [issuer] other than recommending the stock to its customers," was an "undisclosed payment[ ]" to a broker that was material information).

That the $350,000 payment is material information is further bolstered by the Securities Act's anti-touting prohibitions. Section 17(b) of the Securities Act of 1933 provides, in pertinent part that "[i]t shall be unlawful for any person . . . to publish, give publicity to, or circulate any . . . communication which, though not purporting to offer a security for sale, describes such security for a consideration received, or to be received, directly or indirectly, from an issuer . . ., without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof." 15 U.S.C. § 77q(b). It would be a strange and troubling result for investor protection if payments from an issuer must be disclosed under the anti-touting provisions in a communication that does *not* purport to offer a security for sale, yet not required to be disclosed by a registered representative that, in direct communications with investors, actually offers to sell

the security. Fortunately, such a result is not called for in this case. Both the Securities Act and the Securities Exchange Act rejected the rule of buyer beware and imposed instead full disclosure requirements. *Cf. Affiliated Ute Citizens of Utah,* 406 U.S. at 151 & n.15.

The NAC also correctly found that the "in connection with" prong of Section 10(b) and Rule 10b-5 were met, and applicants make no argument otherwise. Applicants omitted to disclose the facts about their conflicts of interest when selling DEER securities. Their omissions of their conflicts were in connection with the sale of DEER securities. *See SEC v. Zandford*, 535 U.S. 813, 819-22 (2002) (holding that the SEC "has consistently adopted a broad reading" of the phrase "in connection with the purchase or sale of any security" and that it is satisfied when "the scheme to defraud and the sale of securities coincide"); *cf. RichMark*, 57 S.E.C. at 8 (holding that failure to disclose conflict of interest when recommending purchase of stock was violation of anti-fraud provisions); *DuBois*, 56 S.E.C. at 837 (same).

c. Scholander's and Harris' Arguments Lack Merit.

Scholander and Harris renew their argument that a registered representative, as a result of the broker-client relationship, is required to disclose information that concerns "the narrow task of consummating the transaction" and that is "clearly significant"—as if this would somehow exclude their significant conflicts of interest when selling DEER securities. Br. 8. For this argument, applicants cite *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 536 (2d Cir. 1999)). Br. 8. FINRA is aware of no opinions in which the Commission has relied on this aspect of *Press*, let alone used either the "narrow task of consummating the transaction" or "clearly significant" phrases when defining the disclosure obligations under Section 10(b) of the Exchange Act. As the Commission has pointed out, *Press* does not apply to Scholander's and Harris' case because "*Press* concerned whether a broker-dealer is required to disclose a markup

in the context of an arm's length transaction." *Scholander*, 2015 SEC LEXIS 841, at *13 n.10. But even assuming *arguendo* that this is an accurate legal standard, the information that Scholander and Harris failed to disclose *did* concern the specific securities transactions at issue because it was information that would have been important to reasonable investors when engaging in the narrow task of deciding to invest in DEER securities.

In applicants' cramped view, however, the only kinds of information that a registered representative must disclose to his customers are "excessive charges to the customer with respect to that particular transaction" and "the broker or the firm's receipt of additional funds or other financial interest tied to the particular transaction." Br. 8. As examples, applicants cite three cases involving excessive commissions. Br. 8. The essential flaw in Scholander's and Harris' argument is that excessive commission cases do not overrule the prevailing case law that finds undisclosed conflicts of interest to be material omissions.

In *Kunz*, the Commission held that facts such as a "consulting relationship" between broker and the issuer, "consulting fees paid to [the broker] by [the issuer], and [the issuer's] financing of" a broker-dealer that the broker formed are "material to any prospective investor" because "[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." *Kunz*, 55 S.E.C. at 565. *Kunz*'s holding is bolstered by other cases in which courts, the Commission, and other adjudicators have held brokers liable for failing to disclose conflicts of interest or financial self-interests that do not involve excessive commissions or excessive payments for specific transactions. *See, e.g.*, *Chasins v. Smith Barney & Co.*, 438 F.2d 1167, 1171-72 (2d Cir. 1970) (holding that broker's failure to disclose market-making role in a security was an omission of material information because "[i]f over supplied, it may be to

the interest of a market maker to attempt to unload the securities on his retail clients" and that the 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 broker failed to disclose to customers its economic motive to increase the price of securities that it owned or expected to own pursuant to an investment banking agreement with the issuer, and that disclosure was needed so "investors could make an informed judgment"); *Jaloza*, 2009 FINRA Discip. LEXIS 6, at *20 (holding that "member firm's interest in promoting a stock," which was linked to its potential consulting relationship with the issuer, the potential for the member firm to receive options in the issuer's securities, the member firm's position in the stock, and its intent to make a market in the securities, had a "potential effect . . . on [broker's] objectivity" that was material to a reasonable investor).

Having previously failed to persuade the Commission that this argument was a likely winner, applicants return with a new iteration. Now Scholander and Harris contend that the only kinds of conflicts that must be disclosed are those that have a "transactional nexus." Br. 8, 11. But applicants point to no cases that articulate such a standard, let alone in the apparently narrow way applicants would construe it.[12] Rather, the legal standard is that what must be disclosed by

[12] As authority for their "transactional nexus" test, applicants again cite *Press*. Br. 8, 11. But nowhere in *Press* did the court of appeals state that that the only information that must be disclosed is information with a "transactional nexus," let alone in the narrow way applicants would appear to define such a test. Rather, *Press* held that "the fiduciary obligation that arises between a broker and a customer as a matter of New York common law is limited to matters relevant to affairs entrusted to the broker"—which, in *Press*, was a single transaction of purchasing a T-bill—and that a broker has a "duty to use reasonable efforts to give [the customer] information relevant to the affairs that [had] been entrusted." *Press*, 166 F.3d at 536-37. Moreover, *Press* sheds little relevant light on what kinds of conflicts would be "relevant" enough to "the entrusted affairs" to require disclosure, considering that the omitted information at issue in *Press* was a non-excessive $158 markup on a $99,488 purchase. The conflicts at issue here are far different in kind than a non-excessive mark-up in an arm's length transaction.

[Footnote continued on next page]

registered representatives is material information, and that material information exists when it is substantially likely that reasonable investors would consider the information important in deciding how to invest.[13] For all the reasons explained above, applicants' conflicts with DEER were material information. Moreover, Scholander's and Harris' "transactional nexus" test would by duplicative of, or improperly overtake, the "in connection with a purchase or sale of any security" prong of Section 10(b) and Rule 10b-5, which is, as explained above, is broadly construed.[14]

[cont'd]

Indeed, even the Commission distinguished *Press* in its denial of applicants' motion to stay. *Scholander*, 2015 SEC LEXIS 841, at *13 n.10.

Applicants' "transactional nexus" test, as they appear to apply it, also is in conflict with *Dep't of Enforcement v. Jordan*, Complaint No. 2005001919501, 2009 FINRA Discip. LEXIS 15, at *15-23 (FINRA NAC Aug. 21, 2009), in which the NAC held that an analyst's pursuit of employment with the company that was subject of research reports she drafted was material information that should have been disclosed in the research reports. Such a conflict had nothing to do with the result of a specific securities transaction.

[13] As explained in a treatise that extensively explores the requirements of Section 10(b) of the Exchange Act, "[a] broker-dealer must disclose any conflict which could be considered a material fact." 5D Arnold S. Jacobs, *Disclosure and Remedies Under the Securities Laws*, §18.32 ("What must be disclosed?"), at pp. 18-108 to 18-109 (Thomson Reuters 2014). That treatise further explains that conflicts that must be disclosed could include, among other things, "[t]he broker-dealer's relationship with the stock" or—as here—"[t]he relationship of the broker-dealer or its personnel with the issuer, including . . . fees paid to the brokerage firm by the issuer, whether it acted as an underwriter for the company in the recent past, [or] an investment banking relationship." *Id.*

[14] Scholander's and Harris' "transactional nexus" argument is also one that sounds like transaction causation or investor reliance. In a FINRA disciplinary proceeding, however, proof of investor reliance is not necessary to establish a violation involving material misrepresentations of FINRA's and the SEC's anti-fraud provisions. *Dep't of Enforcement v. Apgar*, Complaint No. C9B020046, 2004 NASD Discip. LEXIS 9, at *14 n.11 (NASD NAC May 18, 2004) (citing cases).

Regardless, Scholander and Harris failed to abide by even their own narrow "nexus to the transaction" test. One obvious reason why Scholander and Harris possibly sold such large volumes of DEER securities—given the abundance of circumstantial evidence—is that DEER may have paid them all or part of the $350,000 to do so. Scholander and Harris provided only two hours of advice to DEER in its China offices and participated in a conference call on which they gave "opinions." For just these few hours of work, applicants received an outsized $350,000. As the NAC found, it is reasonable to infer that DEER was expecting something more for its $350,000. Neither Scholander nor Harris ever credibly explained what more was expected for DEER's $350,000, nor is there any direct evidence about what more was expected.[15] Perhaps DEER was looking for Scholander and Harris to provide substantially more advice on how to sell its soy milk makers and juicers, despite no apparent expertise in consumer products retailing or the kitchen appliance market. A *far* more plausible possibility is that in exchange for all or part of the $350,000 payment, DEER was expecting Scholander and Harris to sell DEER securities out of the branch office it funded. And while Scholander's and Harris' brief never exactly defines what it means by their "transactional nexus" test, this possibility is nearly precisely one of the conflicts in *Kunz* that applicants concede would fall within their transactional nexus test. Br. 12 (conceding that money provided by an issuer to finance a broker-dealer that was anticipated to act as selling agent or underwriter for the issuer's private

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[15] *See, e.g.*, RP 555-556, 564-565, 1184-1185 (Scholander falsely testifying that Gearty "provided all of the services that led DEER to pay her $350,000" and claiming to be unaware of what was done to earn the fee); RP 681-684, 718-719, 722 (Harris testifying that Gearty "was going to be doing something for [DEER]," that "we were all expecting that [DEER] would come back and ask for some kind of advice," and that "there was some skepticism at first" about whether to spend the $350,000 they had received); *see also* RP 948, 967 (Gearty testifying that "[t]here was no understanding as to why" DEER was making the $350,000 payment, and that she was not aware of DEER asking for "any work of any kind").

placement offerings was a conflict in *Kunz* that satisfies applicants' "transactional nexus" test). Moreover, Scholander's and Harris' argument ignores that, as the seminal *Chasins* decision held, even *potential* conflicts of interest are material conflicts that must be disclosed. *See Chasins*, 438 F.2d at 1172 (holding that disclosure was required of information that "would indicate the *possibility* of adverse interests which *might* be reflected in [the broker's] recommendations") (emphasis added); *see also Jaloza*, 2009 FINRA Discip. LEXIS 6, at *21 (holding that "potential effect" of firm's beneficial interest in stock was material fact).[16]

Scholander and Harris also contend that to hold them liable for fraud would result in an "untenable standard where any prior dealings with an issuer must be disclosed." Br. 1, 17. But sustaining the NAC's findings of fraud would lead to no such result. Scholander's and Harris' failure did not just involve "any prior dealings with an issuer." Rather, it involved recent and ongoing business dealings with an issuer, a substantial recent payment received from the issuer, an unknown amount of services that were still owed to the issuer for that payment, and a

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[16] Applicants note correctly that there was no testimony that the advisory services that Scholander and Harris provided in exchange for the $350,000 was directly related to sales of DEER stock, and that the NAC referred to the payment as non-transaction based. Br. 9. But as explained above, the circumstantial evidence raises the strong possibility that the $350,000 payment was generally for sales of DEER securities, and it is a misreading of the NAC's decision to suggest that the NAC found that possibility to be foreclosed. In describing the payment as non-transaction based, the NAC was explaining how Scholander and Harris failed to proffer evidence showing how the $350,000 payment from DEER was analogous to transaction-based commissions paid by a broker-dealer, like those at issue in *U.S. v. Skelly*, 442 F.3d 94 (2d Cir. 2006). RP 3403. But the NAC made no finding about what exactly DEER bought, or did not buy, for its money other than unspecified "advisory services." Rather, the NAC stated that "[w]hile 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 DEER payment "was for something more than the services Scholander admitted providing." RP 3400, 3410.

longstanding and ongoing history with the issuer's promoters, all of which gave rise to obvious concerns about Scholander's and Harris' objectivity when recommending the issuer's securities.

Thus, the NAC correctly found that Scholander and Harris made material omissions when soliciting their customers to invest in DEER securities, in violation of their duties as registered representatives.

2. Scholander and Harris Acted with Scienter.

The record also shows that Scholander and Harris acted with scienter. Scienter can be established by showing that the applicants acted recklessly. Recklessness includes "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." *Gebhart*, 2008 SEC LEXIS 3142, at *26 (citing cases). Proof of scienter "is often a matter of inference from circumstantial evidence." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390-91 n.30 (1983); *DuBois*, 56 S.E.C. at 836.

Scholander and Harris knew about the $350,000 payment from DEER, that they were among the primary beneficiaries of that payment, that it funded their plans to acquire their own broker-dealer and build their own branch office, that they had an ongoing business relationship with DEER, that they had longstanding ties to Wey and Newman *and* that their customers were not aware of any of these conflicts of interest. Scholander and Harris either knew, or must have known—especially considering their years of experience in the industry—that failing to disclose this information presented the danger of misleading customers that applicants had no conflicts of interest when selling DEER securities. Scholander's and Harris' knowledge of the danger of misleading their customers satisfies the scienter requirement.

Applicants point to nothing to show that they lacked scienter. Scholander and Harris contend that the "objective component of scienter" is lacking because: (i) Gearty (First Merger's operations manager), Richard Nummi, Esq. (the lawyer retained to assist with the acquisition of First Merger), James Altschul (First Merger's chief compliance officer), and Richard Simonetti (First Merger's president) were all "aware" of the payment; (ii) that "there is no evidence that any of these securities professionals . . . suggested at any point that the Deer Payment needed to be disclosed when selling Deer securities"; and (iii) that this somehow leads to the conclusion that Scholander's and Harris' omissions were not objectively unreasonable. Br. 19-20. These facts, however, reveal nothing about what Scholander's and Harris' colleagues and lawyer believed about applicants' disclosure obligations. Indeed, there is no evidence that Scholander and Harris ever sought these persons' opinions about whether applicants needed to disclose their conflicts of interest, let alone whether these persons held any such opinions or believed that there was no disclosure obligation.[17] In any event, "[t]he purported failure of others to detect or object

[17] For example, applicants cite: (i) James Altschul's investigative testimony that Simonetti did not want his firm to accept the $350,000 because he "didn't know what [the $350,000] is for" (RP 1813); and (ii) Gearty's testimony that Nummi was consulted about how to obtain the $350,000 fee from DEER (RP 965, 1093-1094). Br. 19. Strangely, Scholander and Harris also cite the Letters of Advice, Waiver, and Consent ("AWC") submitted by Altschul and Simonetti—whom applicants anoint as "in the best position to identify that a disclosure was necessary"—in which they consented to disciplinary sanctions for their own related supervisory failures. Br. 19-20. None of this, however, is evidence that Scholander and Harris ever obtained the opinions of Simonetti, Altschul, or Nummi about the disclosure obligations or that such persons believed that Scholander and Harris did not need to disclose their receipt of the $350,000 when selling DEER securities. The only evidence that Scholander and Harris cite concerning what any of their associates thought about the disclosure obligations is Gearty's testimony, taken out of its context, that "I did not know [the $350,000 payment] had to be disclosed." Br. 20; RP 1066. When Gearty's testimony is read in context, however, it is obvious that Gearty held *no* belief about the disclosure issue whatsoever:

[Footnote continued on next page]

to the impropriety of [an applicant's] conduct does not relieve [the applicant] of 'responsibility for what he knew or was reckless in not knowing and for what he did.'" *Joseph John Vancook*, Exchange Act Release No. 61039A, 2009 SEC LEXIS 3872, at *51-52 & n.56 (Nov. 20, 2009), *aff'd*, 653 F.3d 130 (2d Cir. 2011). Scholander and Harris knew about their conflicts of interest, but did not disclose them.

Applicants' argument about the "subjective component of scienter" also lacks merit. Br. 21. They attempt to portray their duty to disclose as falling into "a grey area of the law." Br. 21. But as explained above, a registered representative's duty to disclose their material conflicts of interest when soliciting customers to purchase securities is well-established. In any event, there is no evidence that Scholander and Harris were acting in reliance on any legal opinion concerning their disclosure obligations, let alone a legal opinion that their disclosure obligations were in a "grey area."

[cont'd]

> Q: So did you know during the time frame of February of 2010 to November of 2010 whether the $350,000 that you got from DEER for the trip was being disclosed to the people purchasing?
>
> Gearty: No.
>
> Q: And you did not believe during that time frame that it had to be disclosed, correct?
>
> Gearty: You say "believe." I say I did not know it had to be disclosed.
>
> Q: Okay.
>
> Gearty: It's not a belief. I didn't think about it at all.

RP 1065-1066.

Scholander and Harris also claim that the "subjective component" of scienter is not demonstrated because "[h]ad [applicants] had the 'actual state of mind at the time of the relevant conduct,' . . . one would think that the Deer Payment would not be known by anyone else, let alone the CCO of the firm." Br. 21. The relevant issue for a scienter analysis, however, is whether they knew, or must have known, that failing to disclose their conflicts presented the danger of misleading customers that applicants had no conflicts when selling DEER securities. The fact that Scholander's and Harris' colleagues knew about the fee says nothing about whether applicants knew or must have known of the danger of misleading customers. In fact, even if First Merger supervisors knew of, and acquiesced to, the *misconduct*, that would not refute a finding of scienter. *See Orlando Joseph Jett*, 57 S.E.C. 350, 390 (2004) (rejecting respondent's argument that his giving "full access to his desk and traders during an internal audit" precluded a finding of scienter, and holding that "[e]ven if . . . Jett's supervisors and co-workers knew about his fraud on the firm—indeed even if they ordered him to commit it—that would not relieve Jett of responsibility for what he knew or was reckless in not knowing and for what he did"); *cf. Gebhart*, 2008 SEC LEXIS 3142, at *12 (finding the Gebharts liable for fraudulent sales of notes even where they "made no attempt to hide from [firm] auditors information about the . . . Notes").

In sum, the record supports the NAC's findings that Scholander and Harris fraudulently omitted material conflicts of interest, and applicants have not shown otherwise. The Commission should affirm the NAC's findings in all respects.

B. The NAC Correctly Found that Scholander and Harris Failed to Give Their Member Firm Written Notice of Their Outside Business Activities with DEER.

The Commission should sustain the NAC's findings that Scholander and Harris failed to comply with the requirements in FINRA's rules concerning outside business activities. Indeed, applicants make no argument to the contrary.

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 purpose of NASD Rule 3030 is to ensure that firms 'receive prompt notification of all outside business activities of their associated persons so that the member's objections, if any, to such activities could be raised at a meaningful time and so that appropriate supervision could be exercised as necessary under applicable law.'" *Dep't of Enforcement v. Houston*, Complaint No. 2006005318801, 2013 FINRA Discip. LEXIS 3, at *32 (FINRA NAC Feb. 22, 2013) (quoting Proposed Rule Change by NASD Relating to Outside Business Activities of Associated Persons, Exchange Act Release No. 26063, 1988 SEC LEXIS 1841, at *3 (Sept. 6, 1988)), *aff'd*, Exchange Act Release No. 71589, 2014 SEC LEXIS 614 (Feb. 20, 2014). The rule is intended not only to protect investors, "but also to protect securities firms from potential litigation as a result of the unrevealed, extramural activities of their associated persons." *Dep't of Enforcement v. Schneider*, Complaint No. C10030088, 2005 NASD Discip. LEXIS 6, at *20 (NASD NAC Dec. 7, 2005).

Scholander and Harris defeated these regulatory purposes. 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. In this regard, while Scholander and Harris were registered with Seaboard Securities, they performed consulting services for DEER, and received a $350,000 payment for those services. These activities were sufficient to trigger their notice requirement under NASD Rule 3030. *See Schneider*, 2005 NASD Discip. LEXIS 6, at *13-14 ("[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.").

Scholander and Harris, however, did not provide Seaboard Securities any written notice about their business activities for DEER or the possibility of an advisory fee, let alone a fee as high as $350,000. RP 684-685, 1238-1239. Scholander testified that he orally told a compliance person at Seaboard Securities only that he was going to China "on a due diligence road show" to "see the products" and "as part of [his] work as a broker at Seaboard," which involved purchases and sales of DEER for his Seaboard Securities clients. RP 1238-1239, 1246. Even if true, that did not satisfy the requirements of FINRA's rules. Oral notification to compliance staff was insufficient because NASD Rule 3030 required prompt written notice. And nothing in that oral notification disclosed that he was engaged in business activity for DEER or that he would be compensated for it.

Therefore, the Commission should affirm the NAC's finding that Scholander and Harris failed to provide the required written notice of their outside business activities, in violation of NASD Rule 3030 and FINRA Rule 2010.

C. The Bars Imposed Are Appropriate to Remedy Scholander's and Harris' Fraud.

The NAC correctly concluded that bars were appropriate sanctions to remedy Scholander's and Harris' fraudulent conduct and protect the investing public. The sanctions were consistent with FINRA's Sanction Guidelines ("Guidelines"),[18] and applicants point to nothing that shows that the bars are excessive or oppressive.

The Commission uses the Guidelines as a benchmark when reviewing sanctions imposed in FINRA disciplinary proceedings. *John Joseph Plunkett*, Exchange Act Release No. 69766, 2013 SEC LEXIS 1699, at *42 (June 14, 2013). For intentional or reckless misrepresentations or material omissions of fact, the Guidelines recommend imposing a fine between $10,000 to $100,000, a suspension in any or all capacities of 10 business days to two years, and, in egregious cases, a bar. *Guidelines*, at 88. The Guidelines also contain a number of Principal Considerations in Determining Sanctions ("Principal Considerations") that are considered in conjunction with the imposition of sanctions. *Id.* at 6-7.

The Commission has stated that fraud is "especially serious and subject to the severest of sanctions." *Marshall E. Melton*, 56 S.E.C. 695, 713 (2003). And here, Scholander's and Harris' fraud was accompanied by numerous aggravating factors. It is aggravating that Scholander and Harris fraudulently sold nearly $1 million in DEER securities to 35 customers, over nine

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[18] *See FINRA Sanction Guidelines* (2013), at 88 (Guidelines for Misrepresentations or Material Omissions of Fact), *available at* http://www.finra.org/sites/default/files/Industry/p011038.pdf.

months.[19] It is also aggravating that their misconduct resulted in actual monetary gain.[20] Moreover, applicants continue to blame others—their firms' operations manager, chief compliance officer, president, and lawyer—for their misconduct. Br. 19-20 (arguing that "there is no evidence that any of these securities professionals . . . suggested, at any point, that the Deer Payment needed to be disclosed"). As the NAC explained, "if [applicants'] attempts to blame others show anything, it is that [applicants] have not accepted responsibility for their violations," which is further aggravating. RP 3412 (citing *Castle Sec. Corp.*, 58 S.E.C. 826, 834 (2005) (considering blame-shifting arguments as relevant to sanctions determination)).

It also is aggravating that Scholander and Harris attempted to provide inaccurate or misleading testimony or documentary information to FINRA during its investigation.[21] Scholander provided to FINRA investigators an affidavit in which he falsely distanced himself from the $350,000 payment by inaccurately claiming that the arrangement that led to the $350,000 payment "was between DEER and Gearty" alone. RP 1887-1888. As the NAC explained in a lengthy examination of Scholander's credibility, Scholander's claim that the $350,000 was only Gearty's money was completely implausible.[22] RP 3396-3397. As explained

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[19] *See Guidelines*, at 6, 7 (providing that the Guidelines' "Principal Considerations" include the number, size and character of the transactions at issue; whether the misconduct occurred over an extended period of time; and whether the misconduct was the result of an intentional act, recklessness or negligence).

[20] *See Guidelines*, at 7 (Principal Considerations in Determining Sanctions, No. 16) (providing that a principal consideration is whether the respondent's misconduct resulted in the potential for respondent's monetary or other gain).

[21] *Guidelines*, at 7 (Principal Considerations in Determining Sanctions, No. 12).

[22] Among the numerous reasons why: (1) Gearty was a back office manager, was not a "products expert," and—unlike Scholander and Harris—had never visited an issuer, had never been to China, and had no previous direct business relationship with DEER, Wey, or Newman

[Footnote continued on next page]

above, Scholander also falsely testified at a July 2010 on-the-record interview that he traveled to China just three or four months before, when he was "at" First Merger, when in fact he had traveled there in November 2009 when registered with Seaboard Securities. RP 1887-1888. As the NAC found, Scholander's false testimony about the timing of his China trip was "likely intentional" because "there [is] 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." RP 3411. Likewise, Harris provided false on-the-record testimony that he had not made any financial contributions to the plan to acquire First Merger when, in fact, he had. RP 669. Registered persons who mislead regulators during an investigation present a greater risk of harming the investing public. Scholander's and Harris' untruthfulness during the FINRA proceedings "reflects strongly on [their] fitness to serve in the securities industry." *Burch*, 2011 FINRA Discip. LEXIS 16, at *47.

Although Scholander and Harris claim (Br. 22) that the NAC "did not give adequate consideration to the many mitigating factors," they point to nothing that is mitigating. Applicants contend that their violations "all stem from a single, isolated incident, i.e., the Deer

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[cont'd]

(RP 364, 638, 911-912, 917-918, 944, 949, 971, 1121-1122, 2415-2416, 2417); (2) the suggestion that Gearty earned $350,000 in less than two hours from a company with which she had no prior business relationship was simply not believable; (3) the use of the $350,000 towards the acquisition of a broker-dealer of which she would own only 1% was inconsistent with the $350,000 being only Gearty's money; (4) Scholander's claim that he went to China only to conduct "due diligence" was not credible because all he did was visit DEER's offices for two hours and look at its kitchen appliance products, yet never talked with any DEER executives about DEER's business prospects or visited any factories (RP 1233-1235); and (5) Scholander's claim that the $350,000 was only Gearty's money was at complete odds with his earlier investigative testimony that he, Harris, Zakai, and Gearty had provided advice for the $350,000. Scholander and Harris have made no attempt to stick by their utterly unbelievable assertion that the $350,000 was only Gearty's money.

payment," and imply that their conduct did not involve numerous acts or occur over an extended period of time. Br. 22-23. But this grossly understates the severity of their misconduct, ignores reality, and is plainly wrong. As the NAC found, Scholander and Harris fraudulently omitted to disclose their conflicts of interest to 35 customers, over nine months, in sales that approached $1 million. In addition, applicants' focus on "the DEER payment" glosses over that their failing to disclose the $350,000 from DEER was—while a serious omission by itself—not the full extent of their fraudulent omissions. Rather, Scholander and Harris also failed to disclose the conflicts of interest that derived from their ongoing business relationship with DEER, which arose from their longstanding and lucrative relationship with Wey and Newman.

Scholander and Harris also incorrectly assert that it is mitigating that "neither [applicants'] customers nor the investing public were injured." Br. 23. The NAC made no findings whether there was, or was not, customer harm, and applicants point to no evidence that their First Merger customers were not harmed. *See* RP 3134 (Enforcement counsel arguing that applicants "didn't present any evidence about that, because the stock tanked"). In any event, the absence of customer harm is not a mitigating factor "as [the] public interest analysis focuses . . . on the welfare of investors generally." *Howard Braff*, Exchange Act Release No. 66467, 2012 SEC LEXIS 620, at *26 (Feb. 24, 2012) (quotation marks and brackets omitted); *see also Scholander*, 2015 SEC LEXIS 841, at *19 & n.16 (citing cases for the principle that a lack of customer harm is not mitigating).

Scholander and Harris cite their lack of disciplinary history. Br. 24. Such a factor, however, is not mitigating "because an associated person should not be rewarded for acting in accordance with his duties as a securities professional." *Houston*, 2014 SEC LEXIS 614, at *30;

see Scholander, 2015 SEC LEXIS 841, at *18-19 ("[A]s the Commission has held consistently, a lack of disciplinary history is not mitigating for sanctions purposes.") (citing cases).

Scholander and Harris argue that their conduct was, "at most, negligent." Br. 24. But that is belied by the nature of fraud itself, a scienter-based offense. As explained above, the NAC correctly found that Scholander and Harris acted recklessly when omitting their conflicts from their customers.

Scholander and Harris next contend, citing Principal Consideration Number 15 of FINRA's Sanction Guidelines, that they "did not fail to disclose the DEER payment . . . 'notwithstanding prior warnings from FINRA, another regulator, or a supervisor . . . that the conduct violated FINRA rules or applicable securities laws or regulations." Br. 24. While engaging in misconduct notwithstanding prior warnings can be an aggravating factor, there is no apparent reason why engaging in misconduct where there is an absence of prior warnings should be mitigating.[23]

Scholander's and Harris' comparisons to the sanctions sustained in *Kunz* are of no import. Br. 24-25. As the Commission has often stated, "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." *Kaminski*, 2011 SEC LEXIS 3225, at

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[23] *See, e.g., Dep't of Enforcement v. Cohen*, Complaint No. EAF0400630001, 2010 FINRA Discip. LEXIS 12, at *46 n.28 (FINRA NAC Aug. 18, 2010) (finding that the presence of prior warnings from regulators was aggravating), *aff'd sub nom. Dennis S. Kaminski*, Exchange Act Release No. 65347, 2011 SEC LEXIS 3225 (Sept. 16, 2011); *Guidelines*, at 6 (explaining that "some considerations have the potential to be only aggravating or only mitigating" and that "the presence of certain factors may be aggravating, but their absence does not draw an inference of mitigation").

*41 (citing cases); *see also Scholander*, 2015 SEC LEXIS 841, at *21 (citing cases).[24] The Commission should similarly reject Scholander's and Harris' comparisons to the sanctions that Altschul and Simonetti consented to in AWCs for their related supervisory failures. Br. 24-26. "[C]omparisons 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) (cited in *Scholander*, 2015 SEC LEXIS 841, at *21). Further, "[l]itigated cases typically present a fuller, more developed record of facts and circumstances for purposes of assessing appropriate sanctions than do settled matters." *Scholander*, 2015 SEC LEXIS 841, at *21 (citing *Houston*).

Scholander and Harris also make the confusing argument that "this is precisely the type of case where batching of the violations would be most appropriate." Br. 23. The Guidelines explain that "[a]ggregation or 'batching' of violations may be appropriate for purposes of determining sanctions in disciplinary proceedings" and that "[t]he range of monetary sanctions in each case may be applied in the aggregate for similar types of violations rather than per individual violation." *See Guidelines*, at 4 (General Principles Applicable to All Sanction Determinations, No. 4). The NAC, however, could not have batched applicants' numerous fraud violations any more than it did. The complaint charged fraud in a single cause of action, and the

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24 In any event, the sanctions imposed in *Kunz* were based on, among other things, the NAC's "express[ ]" finding that "respondents acted negligently, not recklessly or intentionally" when omitting material conflicts. *Dist. Bus. Conduct Comm. v. Kunz*, Complaint No. C3A960029, 1999 NASD Discip. LEXIS 20, at *68 (NASD NAC July 7, 1999). In contrast, Scholander's and Harris' omissions were fraudulent.

NAC did not impose a sanction for each individual fraudulent solicitation, but imposed a single bar for applicants' fraudulent solicitations in the aggregate.[25]

Even if the NAC could have batched the violations any more than it did, the kinds of circumstances that may warrant batching in some cases are not present here. *Guidelines*, at 4 (explaining the limited circumstances in which batching of violations "may be appropriate"). By its very nature, fraud does not involve "unintentional or negligent" conduct. *Id.* In addition, this is not a case where it was proved that the violative conduct "did not result in injury to public investors." *Id.* Nor is this a case where "the violations resulted from a single systemic problem or cause that has been corrected." *Id.*

If what Scholander and Harriss really mean by "batching" is that the NAC should have just ignored the troubling facts that they engaged in dozens of fraudulent solicitations over several months, that argument is undermined by the very portion of the Guidelines upon which they rely. In addition to explaining when batching "may" be appropriate, the guidance on batching continues as follows: "[d]epending on the facts and circumstances of a case, however, multiple violations may be treated individually such that a sanction is imposed for each violation. In addition, *numerous, similar violations may warrant higher sanctions, since the existence of multiple violations may be treated as an aggravating factor*." *Id.* at 4; *see also Guidelines* at 6 (Principal Considerations in Determining Sanctions, No. 8) (directing adjudicators to consider "[w]hether the respondent engaged in numerous acts and/or a pattern of misconduct"). Here, the

[25] *Cf. Morton Bruce Erenstein*, Exchange Act Release No. 56768, 2007 SEC LEXIS 2596, at *35-36 (Nov. 8, 2007) (concurring with FINRA's assessment to "aggregate" two causes of action for purposes of determining sanctions), *aff'd*, 316 F. App'x 865 (11th Cir. 2008); *Dep't of Enforcement v. Fox & Co. Invs., Inc.*, Complaint No. C3A030017, 2005 NASD Discip. LEXIS 5, at *37-38 (NASD NAC Feb. 24, 2005) (assessing a single set of sanctions for related net capital, recordkeeping, and FOCUS report violations), *aff'd*, 58 S.E.C. 873 (2005).

NAC's treatment of the numerous instances of fraudulent omissions as an aggravating factor is consistent with the Guidelines.

In sum, the bars imposed by the NAC are consistent with the *Guidelines* and appropriate to protect the public. Scholander and Harris engaged in fraud, there are numerous aggravating factors, and no mitigating ones. The Commission should sustain the bars.

D. Three-Month Suspensions and $15,000 Fines Would Be Appropriate Sanctions for Scholander's and Harris' Outside Business Activities Violations.

For Scholander's and Harris' failure to notify Seaboard Securities of their business activities with DEER, the NAC did not impose any separate sanction, but explained that a three-month suspension and a $15,000 fine, imposed on each applicant, would have been appropriate. RP 3413. Applicants' challenge to this aspect of the NAC's decision fails.

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. *Guidelines*, at 13 (citing the Guidelines' General Principles Applicable to All Sanction Determinations, No. 6). 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. *Id.* at 13.

Here, there is aggravating conduct. One of the Principal Considerations specific to outside business activities violations is "[w]hether the outside activity involved customers of the firm." *Guidelines*, at 13 (Principal Considerations in Determining Sanctions, No. 1). The

outside activity involved providing advisory services to DEER. Although Scholander and Harris claim that DEER was only an issuer of securities (Br. 27), DEER was also a customer of Seaboard Securities. While at Seaboard Securities, Scholander and Harris handled one part of a private placement for DEER. Thus, DEER was an investment banking client of Seaboard Securities.

Another violation-specific Principal Consideration is "[t]he duration of the outside activity, the number of customers, and the dollar volume of sales." *Guidelines*, at 13 (Principal Considerations in Determining Sanctions, No. 3). DEER was the only customer involved in Scholander's and Harris' outside activities, and the NAC found that the duration of the activities was "difficult to assess."[26] Nevertheless, the outside activities generated $350,000, a sizeable amount of revenues.

It is aggravating that the outside business activities violations resulted in Scholander's and Harris' monetary gain (the $350,000 payment). *Guidelines*, at 7 (Principal Considerations in Determining Sanctions, No. 17). Moreover, applicants were veterans of the securities industry and certainly understood their obligations under NASD Rule 3030. RP 714-715 (Harris admitting to his understanding of the Rule 3030 obligation). It is also aggravating that Scholander provided inaccurate on-the-record testimony about the timing of his China trip that appears to have been an effort to conceal his outside activities from a regulator. *Guidelines*, at 7 (Principal Considerations in Determining Sanctions, No. 12) (directing adjudicators to consider "[w]hether the respondent attempted to . . . conceal information from FINRA, or to provide

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[26] RP 3413. Considering the circumstantial evidence that Scholander and Harris had not provided all of the services that DEER bought for its $350,000, the duration of the outside activities appears to have been open-ended.

inaccurate or misleading testimony or documentary information to FINRA). As explained above, Scholander falsely testified at a July 2010 on-the-record interview that he traveled to China just three or four months before when registered with First Merger; in fact, he traveled there in November 2009 when registered with Seaboard Securities. RP 1888. As the NAC found, this false testimony was likely intentional. RP 3411.

There are no mitigating factors. Scholander and Harris argue that "[t]here was . . . no evidence . . . that [applicants] misled Seaboard Securities or actively concealed the [outside business activities] from Seaboard Securities." Br. 28; *see Guidelines*, at 13 (Principal Considerations in Determining Sanctions, No. 5). But applicants painted a far different picture in the proceedings below. Before the NAC, Scholander and Harris suggested that their not disclosing the $350,000 to Seaboard Securities was purposeful, because to disclose "would have telegraphed their departure and have caused their immediate termination." RP 2941, 2970. Their claims that they did not actively conceal their outside activities are further undermined by the fact that Scholander gave Seaboard Securities false and misleading information about the purpose of his visit to DEER. Scholander claims to have orally informed Seaboard Securities that he was visiting DEER only to do a "due diligence road show" and "as part of [his] work as a broker at Seaboard" because he was "engaged in purchases and sales of DEER for clients of [Seaboard]." RP 633-636, 1238-1239, 1246. His claimed due diligence efforts are belied, however, by the fact that all Scholander did during his trip was visit DEER for just two hours, look at its kitchen appliances, visit a mall to see a DEER display, and provide DEER with the advisory services that led to the $350,000 payment. RP 952-958.

Scholander and Harris argue that the absence of evidence of customer harm is mitigating, and they attempt to analogize to the sanctions imposed in *Schneider*, Complaint No. C10030088,

2005 NASD Discip. LEXIS 6 (NASD NAC Dec. 7, 2005). Br. 27, 28-29. These are essentially the same arguments they raised in defense of the fraud allegations, and fail for the same reasons.[27]

Finally, three-month suspensions and $15,000 fines are on the *low* end of the relevant sanctions range. Where there are aggravating factors, the Guidelines recommend a suspension up to one year and a fine up to $50,000 *plus* "the amount of a respondent's financial benefit," which, in this case, was another $350,000.

In light of all the aggravating factors and the absence of any mitigating ones, three-month suspensions and $15,000 fines were consistent with the Guidelines and would have been appropriate to remedy Scholander's and Harris' failure to provide their firm with notice of their outside activities. These sanctions also serve the beneficial and important purpose of deterring others in the industry from engaging in similar violations of FINRA's outside business activities rule. The Commission should not disturb this aspect of the NAC's decision.

V. CONCLUSION

The record supports the NAC's findings that Scholander and Harris engaged in numerous fraudulent solicitations and failed to provide their firm with notice of their outside business activities. The bars imposed will deter Scholander and Harris from engaging in future fraudulent

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[27] In any event, unlike here, in *Schneider* there was no evidence that the outside business activities generated any compensation. *Schneider*, 2005 NASD Discip. LEXIS 6, at *16 n.5.

omissions and will protect investors. The Commission should affirm the NAC's decision in all respects.

Respectfully submitted,

Michael J. Garawski
Associate General Counsel
FINRA
1735 K Street, N.W.
Washington, DC 20006
Tel.: (202) 728-8835

Dated: May 11, 2015

CERTIFICATE OF COMPLIANCE

I, Michael J. Garawski, certify that the foregoing FINRA's Brief in Opposition to Application for Review (File No. 3-16360) complies with the length limitation set forth in SEC Rule of Practice 450(c). I have relied on the word count feature of Microsoft Word in verifying that this brief contains 13,135 words.

Michael J. Garawski
Associate General Counsel
FINRA
1735 K Street, N.W.
Washington, DC 20006
(202) 728-8835

Dated: May 11, 2015