**NASD REGULATION, INC.**
**OFFICE OF HEARING OFFICERS**

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| DEPARTMENT OF ENFORCEMENT,<br><br>Complainant,<br><br>v.<br><br>TIMOTHY JAMES FERGUS<br>(CRD #1995006),<br>Lisle, IL<br><br>Respondent. | Disciplinary Proceeding<br>No. C8A990025<br>(Consolidating C8A990025,<br>C8A990026 and C8A990027)<br><br>**HEARING PANEL DECISION**<br><br>Hearing Officer - SW |
| DEPARTMENT OF ENFORCEMENT,<br><br>Complainant,<br><br>v.<br><br>FRANK THOMAS DEVINE<br>(CRD #2035363),<br>Oswego, IL<br><br>Respondent. | |
| DEPARTMENT OF ENFORCEMENT,<br><br>Complainant,<br><br>v.<br><br>RICHARD ALAN BLAKE<br>(CRD #813822),<br>DeKalb, IL<br><br>Respondent. | Date: June 13, 2000 |

## Digest

The Department of Enforcement filed Complaints against Respondents Timothy J. Fergus, Frank T. Devine, and Richard A. Blake (collectively the "Respondents"). The Complaints alleged that the Respondents sold promissory notes of PCO, Inc. ("PCO") to the public without prior written notice to, and approval of, their employer, in violation of NASD Conduct Rules 2110 and 3040.

Each of the Respondents filed an Answer that admitted participation in the sales of the PCO promissory notes, but denied the violations, arguing that the PCO promissory notes were not securities. Based on the evidence presented at the Hearing, the Hearing Panel determined that the PCO promissory notes were securities, and that the Respondents violated Conduct Rules 2110 and 3040.

The Hearing Panel fined Respondent Blake $35,000, suspended him for 90 days, and required that he requalify as an investment company and variable contracts products representative. The Hearing Panel fined Respondent Devine $34,825.42 ($25,000 plus $9,825.42, the amount of PCO commissions that he retained), suspended him for 45 days, and required that he requalify as an investment company and variable contracts products representative. The Hearing Panel fined Respondent Fergus $8,000, suspended him for 30 days, and required that he requalify as an investment company and variable contracts products representative. The Hearing Panel also ordered each Respondent to pay 1/3 of the $4,242.85 costs of the Hearing.

## Appearances

Daniel P. Moakley, Regional Counsel, Chicago, Illinois, for the Department of Enforcement.

Stephen B. Diamond and Michael Hilicki, Chicago, Illinois, for Respondents Richard A. Blake and Timothy J. Fergus.

David A. Genelly, Chicago, Illinois, for Respondent Frank T. Devine.

## DECISION

### I. Procedural Background

The Department of Enforcement filed three separate Complaints against the Respondents on March 12, 1999. Each Complaint contained one cause of action alleging that between February 1997 and March 1997, each Respondent offered and sold to customers, for compensation, securities in the form of PCO promissory notes without prior written notice to, and approval of, his employer, USLife Equity Sales Corp. ("USLife Equity"), in violation of Conduct Rules 2110 and 3040.

After issuing a notice proposing to consolidate the three Complaints on April 16, 1999, and after considering the Respondents' opposing arguments, the Chief Hearing Officer issued an order consolidating them on May 11, 1999.

The Hearing Panel conducted a consolidated Hearing in Chicago, Illinois, on November 8 and 9, 1999.[1] In addition to the testimony of the Respondents, Enforcement offered the testimony of FL (an attorney who was a neighbor of, and a PCO customer of, Respondent Blake) and Randolph Hill (USLife Equity's former compliance officer). The Hearing Panel also admitted the 15 exhibits that Enforcement offered as evidence. The Respondents and their current employer's compliance officer testified on their behalf. The Respondents also offered 23 exhibits, which the Hearing Panel admitted. The Hearing Panel also admitted three joint stipulations of facts, which the Parties submitted.[2] Subsequently, the record was supplemented by Respondents Blake and Devine.

[1] References to the record are as follows: "Tr." refers to the transcript of the Hearing held on November 8, and 9, 1999; "CX" refers to Complainant's Exhibits offered at the Hearing; and "RX" refers to the Respondents' Exhibits offered at the Hearing.

## II. Findings of Facts and Conclusions of Law

### A. Jurisdiction

Respondents Blake, Devine, and Fergus were associated with USLife Equity as investment company and variable contracts products representatives from January 1996 to April 1997, from September 1996 to April 1997, and from October 1996 to April 1997, respectively. (CX-2, p. 1; CX-1, p. 1; CX-3, p. 1). Currently, the Respondents are associated with La Salle Street Securities, Inc. in the same capacity. (CX-2, p. 2; CX-1, p. 2; CX-3, p. 2).

Accordingly, the Hearing Panel determined the Association has jurisdiction over the Respondents.

### B. Background

At the time of the PCO promissory note sales, Respondent Blake had been an insurance agent for 23 years. (Tr. p. 127). Respondent Devine and Respondent Fergus had been insurance agents for approximately 10 years. (Tr. pp. 244, 429). For most of their careers, the Respondents sold insurance products; more recently, they have sold more variable annuities and mutual funds. (Tr. pp. 220, 244, 435, 531). Their securities registrations were necessary to sell variable annuity products and mutual funds.

USLife Equity terminated the Respondents in April 1997 for unauthorized and undisclosed outside business activities, after conducting an internal investigation, in which USLife Equity discovered

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[2] Statements in the Joint Stipulation as to Facts between Respondent Blake and Enforcement are referred to as "BStip at ." Statements in the Joint Stipulation as to Facts between Respondent Devine and Enforcement are referred to as "DStip at ." Statements in the Joint Stipulation as to Facts between Respondent Fergus and Enforcement are referred to as "FStip at"

that the Respondents sold PCO promissory notes.[3] (BStip at 2; DStip at 2; FStip at 2). Upon reviewing the Form U-5s, the NASDR staff began the investigations that culminated in the March 12, 1999 Complaints. (CX-7).

Respondents admitted that they sold PCO promissory notes and that they did not provide any written notice to USLife Equity. (BStip at 8; DStip at 8; FStip at 8).

**C. Sales of PCO Promissory Notes by Respondents**

The Respondents admitted soliciting the sales of PCO promissory notes pursuant to an agent commission agreement with the marketing arm of PCO. The commission agreement provided the Respondents would immediately receive a commission based on the amount of funds deposited with PCO. (CX-7, pp. 3, 7, 11).

Respondent Blake solicited sales of PCO promissory notes for approximately four and a half weeks in February and March 1997. (BStip at 6). He sold 20 customers, including his neighbor Attorney FL, approximately $1.7 million in PCO notes, without advising USLife Equity. (BStip at 6). Respondent Blake invested $133,674 of his own money, and Respondent Blake's father invested $95,000 in the PCO promissory notes. (BStip at 6; Tr. p. 189). Approximately 70% of the investments solicited by Respondent Blake involved funds from retirement accounts. (Tr. p. 229). Respondent Blake received total commissions of $14,450 for introducing investors to PCO.[4] (BStip at 7).

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[3] At the time the Respondents' Form U-5s were filed, the USLife Equity compliance officer did not have sufficient information about the PCO promissory notes to determine whether they were securities. (Tr. p. 71).

[4] Although the $14,450 commission was in excess of the 4% commission rate set forth in Respondent Blake's January 27, 1997 agency agreement with M.D. Smith, Respondent Blake received his commissions from PCO through his spouse, who, acting as a conduit for Respondent Blake, signed an agreement with M.D. Smith at a 5% commission rate. (Tr. pp. 151-153, 217, 227).

From late February to March 1997, Respondent Devine successfully solicited five sophisticated investors, who invested $898,749.90. (DStip at 6; Tr. p. 485). Respondent Devine received total commissions of $19,661.92.[5] (DStip at 7).

Between late February and March, Respondent Fergus sold the promissory notes to three investors for $132,950.15. (FStip at 4; Tr. p. 242). Respondent Fergus personally invested $64,545.33 in the PCO promissory notes. (FStip at 4; Tr. p. 261). Respondent Fergus did not receive any commissions from PCO. (FStip at 4; Tr. p. 264).

**D. PCO Promissory Notes Were Securities**

The Respondents principally argued that the PCO promissory notes were not securities, and, therefore, were not subject to the requirements of Rule 3040, based on the Court of Appeals' analysis in SEC v. Life Partners, Inc., 87 F.3d 536 (D.C. Cir.) reh'g denied, 102 F.3d 587 (D.C. Cir. 1996). Respondents argued that the Life Partners' holding that viatical settlements were not securities under the investment contract test set forth in SEC v. W. J. Howey Co., 328 U.S. 293 (1946) should be applied in this case, as well.

However, the investment instruments at issue in this case are "notes," not "viatical settlements." Enforcement argued that the proper analysis for determining whether the PCO promissory notes were securities was not the investment contract analysis of the Howey test, but the family resemblance test applied to notes as articulated by the Supreme Court in Reves v. Ernst & Young, 494 U.S. 56 (1990). In Reves, the Supreme Court explained:

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[5] According to the agency agreement, Respondent Devine was entitled to commissions totaling $35,000. (CX-9, p. 2).

> We reject the approaches of those courts that have applied the Howey test to notes; Howey provides a mechanism for determining whether an instrument is an 'investment contract.' The demand notes here may well not be 'investment contracts,' but that does not mean they are not 'notes.' To hold that a 'note' is not a 'security' unless it meets a test designed for an entirely different variety of instrument would make the [Securities] Acts' enumeration of many types of instruments superfluous . . . .[6]

The Hearing Panel agrees that the correct analysis is the Reves test. Nevertheless, because the Respondents relied so heavily on the Howey investment contract test as applied in Life Partners, the Hearing Panel first considers whether the instruments at issue in this case satisfy the Howey test before considering the application of the Reves test.

### 1. PCO Promissory Notes Were Securities Under an Investment Contract Analysis

#### a. Viatical Settlements

Viatical settlements are investment contracts pursuant to which investors acquire interests in the life insurance policies of terminally ill persons at a discount, depending upon the insureds' life expectancies. When the insureds die, the investors receive the insurance benefits. In Life Partners, decided in 1996, the U. S. Court of Appeals for the District of Columbia Circuit held that certain viatical settlements were not securities under the Securities Act of 1933.

In the viatical settlements at issue in Life Partners, the investors acquired ownership interests in particular insurance policies. After the investors purchased the ownership interests in particular policies, Life Partners provided post-purchase functions in the form of administrative services: monitoring the insureds' health, assuring that the policies did not lapse, converting group policies into individual policies where required, and arranging for resales of investors' ownership interests in policies when requested and feasible.

[6] Reves, 494 U.S. at 64.

In addition to its program for individual investors, Life Partners developed a plan for investors to participate in viatical settlements through individual retirement accounts ("IRAs"). Because the Internal Revenue Code prohibited investments in life insurance policies by IRAs, Life Partners structured the purchases through separate trusts that Life Partners created for each investor's IRA. The IRAs would lend money to the trusts in exchange for non-recourse notes. The trusts would use the loan proceeds to purchase viatical settlements and the proceeds of the life insurance policies would collateralize the loans. When the insured died and the insurance proceeds were paid to the trusts, the trusts, in turn, paid the proceeds to the IRAs to pay off the trusts' notes.

The Court of Appeals in Life Partners held that viatical settlements and the accompanying notes were not securities based on its interpretation of the Supreme Court's Howey decision. In Howey, the Supreme Court stated that an investment contract is a security only if investors purchase it with (1) an expectation of profits arising from (2) a common enterprise that (3) depends upon the efforts of others. Because Life Partners brought together multiple investors and aggregated the investors funds to purchase the death benefits of insurance policies in expectation of profits, the Court of Appeals held that the purchase of viatical settlements satisfied the first two prongs of the Howey test.[7]

However, the Court of Appeals reasoned that the viatical settlements did not satisfy the third prong of the test because the investors' profits were not derived predominately from the efforts of others. Although Life Partners provided certain post-sale services, the Court of Appeals held that the only variable affecting the profits to be obtained by the investors was the timing of the insureds' deaths, which was outside of Life Partners' control. Thus, the Court of Appeals held that Life Partners' post-

sale activities were "ministerial" rather than "entrepreneurial." Because these ministerial activities did not have a predominant impact on investors' profits, the viatical settlements did not satisfy the third prong of the Howey test, and thus were not securities.

The Court of Appeals also held that the non-recourse promissory notes issued by the investors' trusts to the IRA accounts were not securities. The economic substance of the non-recourse promissory notes were the same as the purchase of the viatical settlements; the trusts' promissory notes were simply devices to allow investors to purchase viatical settlements through their IRAs. Since the underlying viatical settlements were not securities, neither were the notes.[8]

**b. PCO Promissory Notes**

PCO, owned and operated by its president, David Laing, marketed itself as a firm involved in the viatical settlement business. PCO represented that it was in the business of purchasing insurance policies owned by persons with life expectancies of six months or less.[9] (RX-10, pp. 11, 62). In fact, PCO did not use the funds to purchase insurance policies; it was a fraud.[10] (RX-13, p. 8). According to its marketing literature and sample documents, PCO would purchase a dying insured's policy at a

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[7] The investor's profit on a viatical settlement is the difference between the discounted purchase price paid to the insured and the death benefit collected from the insurance company, less transactions costs, premiums paid, and other administrative expenses.

[8] Life Partners, 87 F.3d at 548.

[9] Prudential, an insurance carrier identified as the issuer of policies purchased by PCO, had no records reflecting any viatical settlement agreements or assignments of benefits involving Mr. Laing, PCO, or Escrow Plus. (RX-13, p. 11). Although PCO indicated that it purchased group policies from insureds in every state, irrevocable assignments of group life insurance policy benefits were illegal in 49 states. (RX-13, p. 11).

[10] The president of PCO's escrow agent authorized the disbursement of funds from the escrow account to pay the personal expenses of Mr. Laing, president of PCO, without verification of the purchase of insurance policies. (RX-13, p. 10). By March 28, 1997, approximately $38 million had been disbursed to Mr. Laing. (RX-13, p. 8). PCO went into bankruptcy and had a receiver appointed by the Los Angeles California Superior Court on April 24, 1997. (RX-19, p. 1).

discount of 50% of the policy's face value, and the insured would make an irrevocable assignment of the policy to PCO or David Laing. (CX-10, pp. 29, 51).

PCO borrowed funds from investors, representing that the funds would be used to purchase dying insureds' insurance policies. (RX-12, p. 4). PCO directed investors to send their investments to Escrow Plus, Inc. ("Escrow Plus") to be deposited into an escrow account at Home Savings of America, Federal Savings Bank. (RX-10, p. 62). Through investments in the PCO promissory notes, more than 1,500 investors loaned approximately $90 million to PCO. (RX-19, p. 6).

Investors were told that Escrow Plus would transfer funds from the escrow account to PCO only after PCO delivered verification of the purchase of insurance policies and their face values to Escrow Plus.[11] (CX-10, p. 57). Pursuant to the PCO lender agreement, PCO agreed to pay interest to each investor at an annual rate of 25%, payable semi-annually in two installments.[12] (RX-12, p. 4).

When the insured died, the insurance company was to pay the face amount of the insured's insurance proceeds to Escrow Plus. (RX-10 p. 75). Pooling the insurance proceeds received, Escrow Plus was to pay any interest due to investors, any fees and expenses, including escrow fees, and any remaining profit to PCO. (RX-10, p. 75). Escrow Plus, on behalf of PCO, was to repay the entire principal of the loan to the investor at the end of the one year term from the pooled insurance

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[11] In addition to the borrowed funds, Escrow Plus was to hold the following documents: (1) verification of insurance policy face value; (2) irrevocable change of beneficiary documents; (3) seller agreement; (4) medical records and diagnosis; (5) lender agreement; (6) deposit receipt and instructions; and (7) the authorization of the president of PCO, David Laing, to the insurance company to send beneficiary funds to Escrow Plus. (CX-10, p. 66). Escrow Plus was also to hold the insurance policy as collateral for the lender. (CX-10, p. 29).

[12] The first installment of 12% was payable six months after the initial loan was made, and the second 12½% was payable at the end of the one year term. (RX-10, p. 67). Pursuant to the escrow agreement, Escrow Plus was obligated to retain sufficient funds in the escrow account to pay an investor's first interest payment. (CX-10, p. 57).

proceeds.[13] (RX-10, p. 67). The structure of the transaction made it clear that investors were providing loans to PCO, rather than purchasing ownership interests in insurance policies, i.e., viatical settlements. (RX-10, pp. 62-64).

**c. Application of the Howey Test to the PCO Promissory Notes**

The Respondents argued that the proceeds of insurance policies were to be used to pay the interest on, and principal of, the PCO promissory notes, similar to the use of insurance proceeds to pay the Life Partners notes. Accordingly, they argued that the insurance proceeds, and not the efforts of others, produced the profits for the PCO notes, and, consequently, the PCO promissory notes, like the viatical settlements in Life Partners, failed to meet the third prong of the Howey test.[14]

However, the structure of the PCO promissory notes differed significantly from the viatical settlements in Life Partners. Unlike the interests sold by Life Partners, PCO was not selling investors viatical settlements or fractional interests in viatical settlements. Instead, PCO was borrowing money from investors and promising to pay them a specified rate of interest over a specified period of time. PCO's obligation to pay its investors pursuant to the PCO promissory notes was not adjusted or modified by whether a particular insured died. Although it was marketed to appear that the proceeds of the insurance policies would be used to repay the PCO promissory notes, the PCO promissory notes did not limit the payment solely to the proceeds of particular insurance policies. The PCO marketing documents stated that the investor did not have to wait for "a single policyholder to expire." (CX-10, p. 76). Thus, unlike Life Partners, PCO investors' profits depended not primarily on receipt of insurance

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[13] The investor had the option of rolling over both the installments of interest as well as the principal and having PCO use those funds to purchase additional insurance policies. (RX-10, p. 67).

[14] The Respondents did not dispute that the PCO promissory notes met the first two prongs of the Howey test.

proceeds into the escrow account but on the entrepreneurial efforts of PCO to attract additional funds to the escrow account to repay investors.[15] Accordingly, the Hearing Panel finds that, rather than an alternative method by which investors acquired ownership interests in specific insurance policies as described in Life Partners, the PCO promissory notes were strictly loans that investors made to PCO with the expectation of earning principal and interest from a common enterprise depending upon the efforts of PCO. Consequently, the PCO promissory notes met all three requirements of the Howey test to be deemed a security.

The Hearing Panel's determination is supported by the NASD's March 1999 Regulatory & Compliance Alert. In the Compliance Alert, NASDR explained that the sale of viatical settlements to investors, described in Life Partners, must be distinguished from the sale of promissory notes to investors to obtain funds to be used to purchase viatical settlements. The Compliance Alert pointed out that, in the promissory note situation, investors do not obtain interests in particular insurance policies. Instead the proceeds of insurance policies are pooled and the investors are paid from this capital pool pursuant to the terms of their notes, which are for a fixed term. Inasmuch as the profits in these arrangements are derived from the post-investment efforts of the promoters, including their skill in selecting the policies to be purchased and other business management activities, the Compliance Alert stated that these activities should be viewed as securities transactions and subject to Rule 3040.[16]

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[15] On at least one occasion, PCO used funds that it had solicited from new investors to make interest payments to earlier investors. (RX-12, p. 5). This is further evidence that the PCO investors' returns were not derived solely from the timing of an insured's death.

[16] 1999 Regulatory & Compliance Alerts--Volume 13, Number 1--Regulatory Short Takes--Viatical Settlements. (March 1999).

**2. The PCO Promissory Notes Were Also Securities under a Note Analysis**

The proper analysis for determining whether the PCO promissory notes are securities is the family resemblance test applied to notes articulated by the Supreme Court in Reves. Under Reves' family resemblance test, every note is presumed to be a security as defined in Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. §78c(a)(10). This presumption may only be rebutted by a showing that the note (1) bears a "a strong family resemblance" to certain types of notes recognized, based on four factors, as falling outside the "investment market" regulated by the federal securities laws; or (2) should be added, based on the same four factors, to the list of excluded notes. This presumption reflects Congress' intent to define the term "security" with sufficient breadth to encompass virtually any instrument that might be sold as an investment.[17]

Under the Reves test, determining whether a particular note resembles the excluded list of notes is made by considering the following four factors: (1) the motivations that would prompt a reasonable seller and buyer to enter into the transaction,[18] (2) the plan of distribution of the note, (3) the reasonable expectations of the investing public, and (4) whether the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering the application of the Securities Acts unnecessary. The absence of any one of these factors does not automatically result in a determination

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[17] Reves, 494 U.S. at 65.

[18] If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security." Id. at 66-67.

that the note at issue is not a security. "Rather, a balancing of the four [factors] must be conducted in order to determine whether, on the whole, the note looks more like a security than not."[19]

The Reves court listed, as notes excluded from the definition of securities, notes delivered in consumer financings, notes secured by mortgages on homes, short-term notes secured by liens on small businesses or some of the small businesses' assets, notes evidencing "character" loans from banks, short-term notes secured by an assignment of accounts receivable, notes which simply formalize an open-account debt incurred in the ordinary course of business, and notes evidencing loans by commercial banks for current operations.[20] First, the presumption is not rebutted because the PCO promissory notes do not bear a resemblance to any of the above types of commercial or consumer notes that were listed as non-securities by the Reves Court.

Second, the presumption is not rebutted because applying the four factors to the PCO promissory notes does not lead to the conclusion that the PCO promissory notes should be added to the list of notes excluded from coverage of the securities laws. With respect to the first factor, there is no dispute that PCO sold the notes to raise money to fund its business of purchasing viatical settlements. Given the generous rate of interest offered by PCO, it is not difficult to conclude that the investors were interested in the notes because they were expected to generate healthy profits. Indeed, Respondent Devine testified that certain investors were upset that the interest rate on the promissory notes was

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[19] In re NBW Commercial Paper Litigation, 813 F. Supp. 7, 12 n.7 (D.D.C., 1992).

[20] Reves, 494 U.S. at 65.

scheduled to decline.[21] (Tr. p. 188). Thus the first Reves factor weighs in favor of finding the notes to be securities.

With respect to the second factor, the Hearing Panel examined the plan of distribution of the PCO promissory notes to determine whether they were instruments in which there was common trading for speculation or investment. The Reves Court held that offer and sale to a "broad segment of the public" would establish the requisite common trading in an instrument.[22] PCO's plan of distribution, which raised in excess of $90 million from more than 1,500 investors, obviously included an offering to a broad segment of the public.[23] Thus, the second Reves factor also weighs in favor of a finding that the promissory notes are securities.

With respect to the third factor, the Hearing Panel finds that the promissory notes were marketed to the public as investments, despite the acknowledgment form contained in the PCO documents, which stated that the investor acknowledged that the PCO promissory note was "not an investment as defined by the Securities and Exchange Commission." (RX-10, p. 81). Respondent Blake described the PCO promissory notes as "less riskier than the stock market with almost as high a return, or as high a return, as you would expect from the stock market." (Tr. p. 215). Respondent Fergus testified he wanted to know if "it was a good investment." (Tr. p. 243). Attorney FL, Respondent Blake's neighbor, stated that Respondent Blake described the PCO promissory notes as

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[21] Effective March 1, 1997, the interest rate on the PCO promissory note was to change from 25% to 21%, with semi-annual payments of 10.5%. (CX-10, p. 30; Tr. p. 292).

[22] Reves, 494 U.S. at 68.

[23] PCO's documents included an executive summary, which stated that PCO projected additional capital requirements of $100 million in 1997 and at least $200 million per year thereafter in order to increase its viatical settlement capacities to meet the increasing market demand. (RX-10, p. 6).

"as a good investment." (Tr. p. 329). A number of Respondent Blake's customers and Respondent Blake invested their retirement funds in the PCO promissory notes. (Tr. p. 229).

The Hearing Panel finds that the self serving acknowledgment form when viewed with the other materials included in the PCO documents did not substantially alter the customers' reasonable belief that the PCO promissory notes were investments. Thus, the third Reves factor weighs in favor of finding that the notes are securities.

With respect to the fourth factor, the notes were not insurance products,[24] nor were they subject to any other special regulatory system, such as state or federal insurance or banking laws. Although the PCO sales literature claimed that the notes were collateralized by insurance policies and that the funds were secured in an escrow account, the evidence indicated that such assertions were false, further indicating the need for the protection afforded by the federal securities laws. Pursuant to the Reves four-factor analysis, the PCO promissory notes are securities.

Accordingly, the Hearing Panel finds that the PCO promissory notes are securities using the Reves test and finds that the PCO promissory notes are securities even using the Howey test.

**E. Respondents Violated Conduct Rules 2110 and 3040**

Rule 2110 requires that members and associated persons "observe high standards of commercial honor and just and equitable principles of trade."

Rule 3040 provides that "no person associated with an NASD member firm shall participate in any manner in a private securities transaction except in accordance with the requirements of this rule." Rule 3040 requires that an associated person who intends to participate in a private securities

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[24] Life Partners, 87 F.3d at 542 (a viatical settlement investment contract is not an insurance product).

transaction, prior to the transaction, must "provide written notice to the member with which he is associated describing in detail the proposed transaction and the person's role therein and stating whether he has received or may receive selling compensation in connection with the transaction . . . ."

Rule 3040 defines a "private securities transaction" as "any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the Commission."

By selling the PCO promissory notes, the Respondents participated in securities transactions outside the scope of their employment with USLife Equity. The Respondents admitted that they did not provide any written notice to USLife Equity about their sales of PCO promissory notes. (BStip at 8; DStip at 8; FStip at 8). Since scienter is not required to find liability under Rules 2110 or 3040,[25] Respondents can be found liable for failing to provide notice to their employer of their selling activities even if they did not know that the products they sold were securities or they were duped by PCO concerning the characteristics of the product.

One of the main purposes of the notification requirement is to protect investors, as well as NASD members, from unscrupulous promoters.[26] If the Respondents had notified USLife Equity of their proposed participation in these transactions, as required, USLife Equity would have been provided

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[25] District Bus. Conduct Comm. for Dist. Number 8 v. Norman M. Merz, Complaint No. C89960094, 1998 WL 1084545 at *10 ( November 11, 1998).

[26] District Bus. Conduct Comm. for Dist. Number 3 v. Norman D. Autry, Complaint No. C3A940001, 1995 NASD Discip. LEXIS 245 at *7 (January 3, 1995).

the opportunity to conduct proper and reasonable due diligence and to disapprove, and hence prohibit, the sale of the PCO promissory notes by the Respondents.[27]

There is a "long-standing and judicially-recognized policy that a violation of another Commission or NASD rule or regulation, including Conduct Rule 3040, constitutes a violation of Conduct Rule 2110."[28] Accordingly, the Hearing Panel finds that the Respondents violated Conduct Rules 3040 and 2110.

## III. Sanctions

Enforcement requested that each Respondent be barred for violating Rule 3040. The failure by a representative to give notice to his NASD member of private securities transactions is a serious offense.[29] When transactions are not disclosed, there is no opportunity for oversight and supervision by the member, investors are exposed to significant risk of loss, and the NASD loses its ability to regulate sales practices.

Respondents argued that even if the PCO promissory notes were determined to be securities, their conduct was reasonable under the circumstances and should not be sanctioned. In determining the sanctions, the Hearing Panel was guided by the NASD Sanction Guidelines for private securities transactions, which suggest a fine ranging from $5,000 to $50,000, to which may be added the amount

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[27] Rule 3040(d)(2) provides that if a member firm approves a representative's participation in a private securities transaction, "the transaction shall be recorded on the books and records of the member and the member shall supervise the person's participation in the transaction as if the transaction were executed on behalf of the member."

[28] In re Stephen J. Gluckman, Exchange Act Release No. 41628 (1999), 1999 WL 507864 at *6 (July 20, 1999).

[29] Ronald J. Gogul, Exchange Act Release No. 35824 (June 8, 1995), 1995 WL 358075 (1995).

of any financial benefit received by the respondent, as well as a suspension for up to two years, or a bar in egregious cases.[30]

The Hearing Panel reviewed the Respondents' conduct and first considered the specific considerations listed in the Guidelines. These included (1) whether the respondent had a proprietary or beneficial interest in, or was otherwise affiliated with the issuer; (2) whether the respondent attempted to create the impression that the employer sanctioned the activity; (3) whether the selling away involved customers of the employer; and (4) whether the respondent provided the employer with verbal notice of all relevant factors of the transaction.[31]

Then, the Hearing Panel considered certain of the general considerations listed in the Guidelines, which included (1) the respondent's relevant disciplinary history; (2) whether the respondent attempted to remedy the misconduct; (3) whether the respondent demonstrated reasonable reliance on competent legal advice; (4) whether the respondent engaged in the misconduct over an extended period of time; (5) whether the respondent engaged in numerous acts of misconduct; (6) whether the respondent attempted to conceal his misconduct or mislead a customer; (7) whether the misconduct resulted in injury to the investing public; (8) whether respondent's misconduct resulted in the potential for respondent's monetary or other gain; (9) whether the respondent's misconduct was the result of an intentional act, recklessness, or negligence; (10) the number, size, and character of the transactions at issue; and (11) the level of sophistication of the injured customers.[32]

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[30] NASD Sanction Guidelines, p. 15 (1998).

[31] NASD Sanction Guidelines, p. 15 (1998).

[32] NASD Sanction Guidelines, Principal Consideration Nos. 1, 3, 7-11, 13, 17-19, pp. 8-9 (1998).

## A. Respondents' Conduct

Respondents argued that their conduct was reasonable for several reasons, the lack of guidance provided by USLife Equity, the information provided by PCO, and their subsequent efforts to assist their customers.

### 1. Lack of Guidance by USLife Equity

The Respondents were licensed as non-exclusive general insurance agents of a USLifeEquity affiliate, All American Life Insurance Corporation ("All American").[33] (Tr. p. 443). The Respondents understood that they were not required to disclose to USLife Equity each specific insurance product that they sold pursuant to agency relationships with other companies.[34] (CX-5, p. 25; Tr. p. 92). The Respondents argued that their general disclosure to USLife Equity, that they were involved in the insurance business with other companies, was sufficient notice to encompass their PCO activities, even though they admitted that PCO was not an insurance company.

On January 29, 1997, All American issued a bulletin to its insurance agents, including the Respondents, setting forth standards for those independent agents involved in viatical settlements. The Bulletin stated:

> The All American Life Insurance Company is philosophically opposed to the use of viatical settlements. We believe that accelerated death benefit provisions are a better method of

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[33] USLife Equity's representative agreement provided that a USLife Equity registered representative must be affiliated with one of the insurance subsidiaries of USLife Equity's holding company and must maintain such affiliation during the term of the agreement. (CX-5, pp. 11, 17, 23). In 1997, USLife Equity's holding company owned three insurance subsidiaries: (1) All American Life Insurance Corporation, (2) United States Life Insurance Company, and (3) Old Line Life Insurance Company. (Tr. 89).

[34] Respondents' view of their obligation to disclose outside activities to USLife Equity was influenced by the USLife Equity Annual Registered Representative Compliance Questionnaire. The Compliance Questionnaire only asked three questions regarding insurance and securities activities: "(1) Are you engaged in or do you derive economic benefit from any business activities other than insurance or securities sales? (2) With which USLife insurance subsidiary are you affiliated? and (3) With which general agency are you affiliated?" (CX-5, pp. 25-26).

achieving this end, and can do so at less cost to the policyholder. As you and your producers are independent contractors, we would not dictate to you how to conduct your business, except as it affects our company. In that regard the following restrictions apply to any agent of All American Life Insurance Company:

1. The agent may not solicit insureds of our company for viatical settlements.

2. In no manner or form can it appear that All American Life Insurance Company is sponsoring the use of viatical settlements.

3. The agent cannot advertise any affiliation with All American Life Insurance Company in the course of doing viatical settlements.

4. Any breach of these guidelines violates the General Agent Agreement and is cause for termination. (RX-5).

Each of the Respondents received and reviewed the Bulletin and believed that the Bulletin provided further evidence that the PCO promissory notes were insurance related.

**2. PCO Documents**

The variety and number of the PCO documents reviewed by the Respondents reassured them that PCO was a legitimate company engaged in the viatical settlement business. The PCO documents included, among other things, examples of the escrow agreement between the lender and Escrow Plus, the acknowledgment and receipt between PCO and the lender, the lender agreement between the lender and PCO, the lender's acknowledgment that the loan transaction was not an investment, an IRS form, an executive summary of the loan transaction, an outline of frequently asked questions, information concerning the insurance companies and Escrow Plus,[35] newspaper articles regarding hospice care and

[35] Escrow Plus was supposedly bonded for $5 million. (CX-10, p. 85).

the viatical industry, and a legal opinion prepared by John Tom Ross that addressed the legality of an insured selling his insurance policy to PCO.[36] (Tr. p. 147; CX-10, pp. 5-103).

The Ross legal opinion also specifically stated "The business of Life Partners is almost identical to the business arrangement between Next Century, Inc. and PCO. Thus under the authority of the Life Partners case, there is no question and it is my opinion that the transaction as structured is not the sale of securities, and thus does not violate such law." (CX-10, p. 66).

**3. Respondents' Conduct after Discovery of the PCO Fraud**

On April 7, 1997, Respondent Devine discovered an article published by Reuters on the Internet, which reported that David Laing, president and owner of PCO, Valerie Jenkins, president of Escrow Plus, and Michael Smith, a PCO broker, were charged by federal prosecutors in the Manhattan federal court with allegedly running a $50 million scheme to defraud investors. (Tr. pp. 492-493; RX-14). Respondent Devine alerted Respondent Blake on April 8, 1997 and Respondent Fergus on April 21, 1997 that there was a possible problem with PCO. (Tr. pp. 192-193, 308). After discovering the fraud, the Respondents promptly contacted their customers, and undertook partially successful efforts to stop payments on checks of certain customers, and assisted their customers in filing claim forms with the PCO receivership. (Tr. 194-195). The Respondents' customers have received approximately 66% of their original investment from the PCO receivership. (Tr. p. 196). It is anticipated that additional payments from the receivership will be made. (Tr. p. 197).

[36] The legal opinion, dated December 4, 1996, was addressed to the president of Next Century, Inc., which was described as the exclusive world-wide agent for PCO. (CX-10, pp. 62-67). Next Century was PCO's marketing agent prior to M.D. Smith. (Tr. p. 423).

## B. Respondents' Individual Conduct

The Respondents also cited their individual due diligence efforts as demonstrating that their conduct was reasonable. The Hearing Panel carefully reviewed the conduct of each Respondent separately to determine what sanctions were warranted. The Hearing Panel found that, although each Respondent had undertaken minimal due diligence efforts, substantial sanctions were warranted in light of the seriousness of the violation.

### 1. Respondent Blake

In the summer of 1996, Respondent Blake saw numerous advertisements in life insurance trade magazines for viatical settlements. (Tr. p. 169). He sent for and reviewed the materials from Mutual Benefit, a viatical company, and provided a copy of the materials to Barry Link, his supervisor at All American and USLife Equity.[37] (Tr. pp. 158, 169). Respondent Blake did not make the necessary distinction between a company, like Life Partners, that markets viatical settlements to investors and a company, like PCO, that markets promissory notes to investors to obtain funds supposedly to purchase viatical settlements.

Respondent Blake discussed viatical settlements generally with Mr. Link in two conversations in late 1996. (Tr. pp. 169, 170-172). In their discussions, according to Respondent Blake, Mr. Link did not raise the possibility that such transactions could be securities. (Tr. p. 30). Respondent Blake also

[37] The Respondents were a part of Mr. Link's network of agents and registered representatives. (Tr. pp. 73, 119). Mr. Link was the general agent in charge of the Respondents for All American, and he had compliance responsibilities for securities activities of the Respondents at USLife Equity. (Tr. pp. 73, 119).

discussed the advantages of selling viatical settlements generally with Respondent Devine and Respondent Fergus in late 1996.[38] (Tr. p. 440).

Respondent Blake, while associated with USLife Equity, executed an agent commission agreement with M.D. Smith, the marketing arm of PCO, on January 27, 1997, pursuant to which he was to receive a 4% commission on the funds he successfully solicited. (BStip at 4; CX-7, p. 11). After Respondent Blake executed the agreement, he received the PCO documents. (Tr. p. 173). Respondent Blake did not provide oral or written notice of this agreement to Mr. Link or any principal at USLife Equity. (Tr. pp. 145-146).

Subsequently, Respondent Blake received the January 29, 1997 All American bulletin regarding viatical settlements. Respondent Blake interpreted the Bulletin to mean All American did not prohibit the sale of viatical settlements, but rather it subjected the sales of the product to certain restrictions. (Tr. pp. 259, 474-475). He viewed the Bulletin as confirming that All American, rather than USLife Equity, supervised the sales of viatical settlements as insurance-related products. (Tr. pp. 259, 473). Upon receipt of the Bulletin, Respondent Blake did not advise Mr. Link, or any principal of USLife Equity, of his involvement with PCO. (Tr. pp. 145-146).

In late January 1997, Respondent Blake provided copies of the PCO documents, including the Ross legal opinion, to his neighbor, Attorney FL, to get his views on the PCO program.[39] (Tr. pp. 155-

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[38] The Respondents knew each other from having worked at Metropolitan Life at the same time. (Tr. 142). After leaving Metropolitan Life, the Respondents continued to have coffee together once or twice a month to discuss business opportunities. (Tr. 142).

[39] Attorney FL testified that he had never done any legal work for Respondent Blake, and Respondent Blake never paid him for any legal work. (Tr. p. 203). Attorney FL's employer prohibited Attorney FL from providing legal advice other than in connection with this employment. (Tr. p. 391). Attorney FL advised Respondent Blake of this prohibition on an earlier occasion when Respondent Blake asked Attorney FL to incorporate a business for him. (Tr. p. 313).

156, 175, 178). Respondent Blake also provided copies of the PCO documents to Respondent Devine and Respondent Fergus. (Tr. p. 175). Respondent Blake began soliciting customers for the PCO promissory notes.

Attorney FL reviewed the PCO documents and obtained and reviewed a copy of the Life Partners decision. (Tr. p. 295). On February 13, or 14, 1997, Attorney FL advised Respondent Blake that the legal opinion included in the PCO documents accurately described the holding of Life Partners that viatical settlements were not securities. (Tr. p. 295). He also requested that Respondent Blake send the PCO documents to Mr. FL's attorney friend, Mr. S, for his views.[40] (Tr. p. 295).

Attorney FL testified that Mr. S told him, on February 18, 1997, that the PCO transactions "did not pass the smell test."[41] (Tr. p. 295). Attorney FL testified that he relayed Mr. S's negative comments to Respondent Blake. (Tr. pp. 299-300). In contrast, Respondent Blake says that Attorney FL stated that he would have written the Ross legal opinion differently, but it was "fine." (Tr. p. 469). On February 25, 1997, Attorney FL, knowing that Respondent Blake was investing his own money, invested $85,000 in the PCO promissory notes.[42] (CX-10, p. 5). The Hearing Panel finds that although Attorney FL did voice some concerns to Respondent Blake about the Ross legal opinion, Respondent

[40] Attorney FL sent Mr. S a copy of the Life Partners decision. (Tr. p. 395). Mr. S was not a securities attorney. (Tr. p. 297).

[41] Mr. S also indicated that (1) the transactions "had the attributes of a ponzy (sic) scheme," (2) the "lender agreement and the escrow agreement constituted a security," and (3) the Ross legal opinion that concluded that the PCO promissory notes were not securities was "not worth much." (Tr. pp. 298-299).

[42] After attending a PCO meeting in Denver, Colorado on February 22, and 23, 1997, Respondent Devine, at the request of Respondent Blake, advised Attorney FL in a brief telephone conversation that PCO was a legitimate company. (Tr. pp. 356, 420, 483).

Blake did not understand that Attorney FL had any serious reservations regarding the Ross legal opinion.[43]

Looking first at the specific considerations listed in the Guideline, the Hearing Panel found Respondent Blake did not have a propriety or beneficial interest in, nor was he otherwise affiliated with PCO, Escrow Plus, or the sales agent, M.D. Smith. (BStip at 12; Tr. 190-191). Respondent Blake did not create the impression that USLife, or All American, sanctioned the sales of the PCO promissory notes. Respondent Blake complied with the restrictions set forth in the All American Bulletin, including the prohibition on soliciting customers of All American, however, he did sell PCO notes to five customers of USLife Equity.[44] (Tr. p. 177; CX-8, p. 3; RX-21, p. 1). Although Respondent Blake discussed the sale of viatical settlements generally with Mr. Link, his conversations did not constitute appropriate notice to his employer of his intention to participate in the PCO transactions. (Tr. pp. 145-146).

In reviewing the general considerations, the Hearing Panel first focused on aggravating factors. Respondent Blake successfully solicited 20 people, ten of whom he solicited prior to the time he states that Attorney FL said the PCO legal opinion was "fine," and prior to the time that Respondent Devine reported the outcome of the Denver "due diligence" meeting. Respondent Blake raised $1.7 million for

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[43] Because Respondent Blake denies that Attorney FL voiced any serious reservations regarding the Ross legal opinion, the Hearing Panel also finds that, when Respondent Blake advised Respondent Devine and Respondent Fergus of Attorney FL's positive views of the Ross legal opinion, he did not relay any of Attorney FL's reservations.

[44] Five of Respondent Blake's PCO customers cashed out policies issued by Security Benefit Life Insurance Company ("Security Benefit"), the annuities of which were listed on USLife Equity's approved product list. (Tr. 131; CX-8, p. 3; RX-21, p. 1). Prior to being associated with USLife Equity, Respondent Blake never sold a Security Benefit product. (Tr. p. 131).

PCO and received commissions of $14,450.[45] There was no evidence that his customers were sophisticated investors. In at least five instances, the investments were made with retirement funds. In addition, having been in the securities industry for more than ten years, Respondent Blake should have known that written notification to his employer of his desire to participate in the PCO transactions was the best due diligence.

Second, the Hearing Panel determined that several aggravating factors, which were present in other private securities cases in which bars were imposed, were not present in this case. The Hearing Panel determined that this was not a private securities case in which Respondent Blake intentionally mislead his customers, omitted material information concerning his involvement with the issuer of the promissory notes, or falsely answered questions concerning the transactions on the routine compliance questionnaires.[46] The Hearing Panel concluded that Respondent Blake was not a knowing participant in the PCO promissory note fraud. Not only did Respondent Blake solicit his father's investment of $95,000 in the PCO promissory notes, but he personally invested $133,674. In addition, other than the events surrounding PCO, Respondent Blake has never been disciplined with regard to either his NASD or his State of Illinois insurance license. (Tr. p. 161). Consequently, Respondent Blake did not have prior relevant disciplinary history as an aggravating factor.[47] The Hearing Panel noted that the lack of prior disciplinary history and the fact that Respondent Blake had not repeated this misconduct since his move to La Salle Securities provided some reassurance that this conduct would not be repeated.

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[45] The Hearing Panel noted that the PCO receiver will subtract the $14,450 in commissions received by Respondent Blake from the $133,674 that he invested in determining the amount of his claim against the receivership. (Tr. p. 153).

[46] Charles E. French, Exchange Act Release No. 37409 (July 8, 1996), 1996 WL 378583 (1996).

[47] Gluckman, 1999 WL 507864 at *8 (1999).

Third, the Hearing Panel viewed the factors that could be described as mitigative. At the time of the violation, USLife Equity was aware that All-American had issued a vague bulletin giving the impression that viatical settlements were permissible under certain circumstances. USLife Equity did not issue a bulletin discussing viatical settlements from the perspective of the securities firm to correct the misimpression of the All American Bulletin.[48] This may have led to some confusion on the part of Respondent Blake. (Tr. pp. 73, 99).

On the other hand, Respondent Blake's purported mitigation concerning his efforts to recover his clients' funds and reliance on counsel were not persuasive. Respondent Blake's effort to recover his clients' funds and the current 66% recovery had less to do with his efforts than with happenstance. Respondent Blake's purported reliance on advice of counsel, encompassed in the Ross legal opinion included in the PCO documents, Attorney Sanchez's verbal reassurances to Respondent Devine at the PCO sales meeting, and Attorney FL's purported legal views, was also not deemed mitigative.[49]

To establish the defense of reliance on advice of counsel, a respondent must show that he (1) made complete disclosure to counsel; (2) sought counsel's advice as to the legality of his conduct; (3) received advice that the conduct was legal and (4) relied in good faith on that advice. None of the Respondents retained Mr. Ross, Attorney Sanchez, or Attorney FL for advice as to the legality of their

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[48] Mr. Hill, the USLife Equity compliance officer, stated that it was against company policy for agents of the life insurance companies to sell viatical settlements, and that USLife Equity helped carry out that policy.

[49] Gilbert M. Hair, 51 S.E.C. 374 (1993) 1993 WL 128737, *3 (1993) (representative was not entitled to rely on representations of the issuer that the Heilbroner Notes were not securities). The Respondents also reviewed an opinion of counsel issued by SH, a Michigan attorney. (RX-7). However, the Respondents' received Mr. SH's opinion on April 13, 1997, after they had made the decision to participate in the PCO sales.

conduct.[50] Even if any of the Respondents had retained counsel and could establish the defense of reliance on advice of counsel with respect to the Ross legal opinion, Attorney Sanchez's verbal reassurances, or Attorney FL's legal views, reliance on advice of counsel does not serve as a substantive defense in this matter because such a defense serves only to negate the element of scienter, and the defense is unavailable in violations, such as a violation of Rule 3040, in which scienter is not an element of the violation.[51]

Although the Hearing Panel was concerned that Respondent Blake appeared to deliberately avoid seeking the advice of his employer, the Hearing Panel concluded that the above factors weighed in favor of a sanction that was substantial, but not at the top of the range. The Hearing Panel determined that a $35,000 fine[52] and a 90 day suspension were appropriate sanctions for Respondent Blake. In addition, noting that Respondent Blake's description of the selling away rule as "prohibiting sales of products not on an approved product list" indicates that he does not have a good grasp of his obligations as an associated person as opposed to an insurance agent, the Hearing Panel ordered Respondent Blake to requalify by examination as an investment company and variable contracts products representative.

**2. Respondent Devine**

Respondent Devine became interested in viatical settlement investments contracts in 1996. In late 1996, Respondent Devine discussed with Mr. Link what a viatical settlement investment contract

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[50] District Bus. Conduct Comm. for Dis. No. 1 v. John Thomas Higley, Complaint No. C01940034, 1997 WL 1121301 at *4 (March 5, 1997). (respondent could not rely on an neighbor's opinion as advice of counsel, when he had not retained neighbor as counsel).

[51] Id.

was and the advantages of selling such a product.[53] (Tr. p. 452). There was no discussion about viatical settlements raising securities issues. (Tr. p. 453). Subsequently, in late 1996, Respondent Devine discussed viatical settlements with Respondent Blake at one of their coffee shop meetings. (Tr. p. 400). In January 1997, Respondent Blake presented PCO as a viatical company on which Respondent Devine and Respondent Fergus should "focus." (Tr. p. 458).

After receiving the PCO documents at the January meeting, Respondent Devine undertook certain negligible due diligence efforts. He contacted M.D. Smith, directly, and obtained PCO's "complete kit." (Tr. p. 401). In addition to reviewing the PCO kit, Respondent Devine, over the next couple of weeks, executed a number of internet searches for information concerning viatical settlements. (Tr. p. 402-404). He contacted the Better Business Bureau, the California State Department of Corporations, the National Association of Viaticals, and the American Association of Viaticals regarding PCO and Escrow Plus and learned that PCO had a pending membership application with the American Association of Viaticals. (Tr. pp. 401-403). During his due diligence search, Respondent Devine found no problems and no complaints regarding PCO or Escrow Plus. (Tr. pp. 403-404). The results of Respondent Devine's due diligence searches were relayed to Respondent Blake and Respondent Fergus.

Respondent Devine also reviewed the All American Bulletin, knew of Attorney FL's view that the Ross legal opinion accurately described the Life Partner's holding that viatical settlements were not securities, and knew of Attorney's FL's intention to invest in the PCO promissory notes. (Tr. p. 469).

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[52] The Hearing Panel did not add Respondent Blake's $14,450 in commissions to the amount of the fine because the PCO receiver withheld the $14,450 from Respondent Blake's distribution.

[53] Respondent Devine had known Mr. Link, a general agent at All American, since 1993, and Respondent Devine became an insurance agent for All American in January 1994. (Tr. pp. 441-442).

After receiving the All American Bulletin, Respondent Devine telephoned John Champion, the vice president of marketing at All American, who confirmed the restriction that All American agents not sell viatical settlements to its customers. (Tr. p. 474).

On February 10, 1997, Respondent Devine, while associated with USLife Equity, executed an agent commission agreement with M.D. Smith. (DStip at 4). Pursuant to the agreement, Respondent Devine was to receive a 5% commission on the funds invested. (CX-7, pp. 3, 7). Respondent Devine did not advise Mr. Link or any principal at USLife Equity of his arrangement with PCO. (Tr. p. 485).

On February 22, and 23, 1997, Respondent Devine attended a PCO "due diligence" meeting in Denver, Colorado (Tr. p. 420). At the meeting, Respondent Devine met Mr. Laing of PCO, Ms. Jenkins of Escrow Plus, Mr. Smith of M.D. Smith, and other individuals who had sold PCO promissory notes. (Tr. p. 188). The individuals reported that their clients had received their semi-annual interest checks on time. (Tr. p. 188). The only concern expressed about the PCO program was that the clients were upset that the interest rate was declining from 25% to 21%. (Tr. p. 188).

As a result of the meeting, Respondent Devine was comfortable that PCO was a legitimate company, the PCO promissory notes were not securities, and his investors' funds would be safe at Escrow Plus. (Tr. pp. 480, 483). The question of whether the PCO promissory notes were securities was raised repeatedly at the meeting. (Tr. p. 420). Respondent Devine specifically discussed whether the PCO promissory notes were securities with Attorney Gordon Sanchez, counsel for PCO or M.D. Smith. (Tr. p. 420). Attorney Sanchez reassured Respondent Devine that the PCO promissory notes were not securities; they were insurance products. (Tr. p. 478). Respondent Devine was particularly impressed with Attorney Sanchez because he had been a prosecutor for the City of Denver. (Tr. p.

420). Respondent Devine was also impressed with Ms. Jenkins, the president of Escrow Plus; he viewed her as a highly successful and articulate businesswoman. (Tr. p. 478). Upon his return from Denver, Respondent Devine reported to Respondent Blake and Respondent Fergus his conclusions that PCO was a legitimate company and the PCO promissory notes were not securities. (Tr. p. 420). Subsequently, Respondent Devine began soliciting for the PCO promissory notes.

First, the Hearing Panel considered the specific considerations listed in the Guideline with respect to Respondent Devine. Respondent Devine did not have a proprietary or beneficial interest in, nor was he affiliated with, PCO, Escrow Plus, or M.D. Smith. (BStip at 12). Respondent Devine honored the restrictions set forth in the All American bulletin. (Tr. 475). He did not create the impression that USLife Equity or All American sanctioned the sales of the PCO promissory notes, and his selling away did not involve any pre-existing USLife Equity customers. However, Respondent Devine also did not provide verbal notice of his transactions to his employer.[54]

Second, the Hearing Panel noted that several aggravating factors were not present. This was not a private securities case in which Respondent Blake intentionally mislead his customers, omitted material information concerning his involvement with the issuer of the promissory notes, or falsely answered questions concerning the transactions on the routine compliance questionnaires. Respondent Devine was not a knowing participant in the PCO fraud. However, Respondent Devine raised $898,749.90 for PCO, and received commissions of $19,661.92.

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[54] Despite Respondent Devine's general discussions with Mr. Link about viatical settlements and Mr. Link's apparent interest in viatical settlements, Respondent Devine did not discuss the PCO transaction with Mr. Link. (Tr. pp. 450-453).

As mitigation, the Hearing Panel noted that the five investors Respondent Devine solicited were sophisticated investors.[55] USLife Equity's failure to discuss viatical settlements in light of the All American Bulletin may have led to some confusion on the part of Respondent Devine. The Hearing Panel also believes that future violations by Respondent Devine are unlikely, in part, because of his otherwise unblemished record for more than ten years in the industry, and because he has not repeated this misconduct since his move to La Salle Securities.

Respondent Devine's other arguments regarding mitigation were not persuasive. The Hearing Panel concluded that the PCO "due diligence" meeting had the appearance of a sales meeting and should not have been relied upon by Respondent Devine. Having testified that "Was this a security?" was one of the questions that was repeatedly raised at the PCO meeting, Respondent Devine should have recognized the repeated question as a red flag and checked with his employer. The Hearing Panel also noted that Respondent Devine's due diligence efforts did not include contacting the State Insurance Commissioner although he claimed the PCO promissory notes were insurance-related products. Accordingly, the Hearing Panel determined that Respondent Devine's due diligence efforts were minimal. The Hearing Panel took particular note that Respondent Devine also appeared to avoid seeking the guidance of his employer regarding the particular PCO promissory notes.

Although Respondent Devine's purported reliance on the Ross legal opinion contained in the PCO documents, the verbal reassurances of Attorney Sanchez at the PCO sales meeting, and the views of Attorney FL as reported by Respondent Blake was not reasonable, the Hearing Panel noted that, unlike Respondent Blake, Respondent Devine waited until after the Denver trip and after hearing

Respondent Blake's characterization of Attorney FL's conversation before soliciting his customers. Similar to Respondent Blake, Respondent Devine's efforts to recover his clients' funds, although commendable, were not seen as greatly mitigative of his misconduct.

Under the circumstances, the Hearing Panel determined that a $34,825.42 fine ($25,000 plus $9,825.42, the commissions he retained)[56] and a 45 day suspension were appropriate. In addition, the Hearing Panel ordered Respondent Devine to requalify by examination as an investment company and variable contracts products representative because the Hearing Panel was concerned that Respondent Devine did not understand adequately his responsibilities as an associated person as opposed to an independent insurance agent.

**3. Respondent Fergus**

Respondent Fergus also became interested in the possibility of selling viatical settlement investment contracts in 1996. Respondent Fergus was present at the late 1996 coffee shop meeting, in which Respondent Devine relayed his conversation with Mr. Link about viatical settlements. (Tr. p. 257). Respondent Fergus also received the PCO documents from Respondent Blake at the January 1997 coffee shop meeting. (Tr. p. 257). After the meeting, Respondent Fergus also contacted M.D. Smith directly to obtain and read PCO's "marketing kit." (Tr. p. 257). Respondent Fergus also obtained and read materials from two viatical companies, Mutual Benefit and Life Partners. (Tr. p. 257).

[55] One of Respondent Devine's customers, who invested $450,000 in the PCO promissory notes, had a net worth of $4 million. (Tr. pp. 487-488). Two other customers had net worths in excess of $2 million. (Tr. pp. 488-490).

[56] Respondent Devine paid the PCO receiver $9,836.50 of the $19,661.92 in commissions he had received. Accordingly, Respondent Devine had retained $9,825.42 in financial benefit from his misconduct.

Respondent Fergus also received the All American Bulletin regarding viatical settlement sales in late January 1997 and believed the PCO promissory notes to be insurance-related. (Tr. p. 258). Although, Respondent Fergus also had a brief conversation with Mr. Link concerning the advantages of selling viatical settlements, he did not discuss his interest in PCO with Mr. Link or any principal at USLife Equity. (Tr. p. 238).

On February 10, 1997, Respondent Fergus, while associated with USLife Equity, executed an agent commission agreement with M.D. Smith, pursuant to which he was to receive a 5% commission. (FStip at 4; CX-7, pp. 3, 7).

In late February 1997, after receiving Respondent Devine's favorable report on the PCO Denver meeting and Respondent Blake's report on Attorney FL's endorsement of the Ross legal opinion, Respondent Fergus determined that the PCO promissory notes were a good product and began soliciting for the PCO promissory notes.[57] (Tr. p. 242).

With regard to the specific considerations listed in the Guideline, Respondent Fergus did not have a proprietary or beneficial interest in nor was he affiliated with PCO, Escrow Plus, or M.D. Smith. (FStip at 12). He did not create the impression that USLife Equity or All American sanctioned the sales of the PCO promissory notes. Respondent Fergus did not solicit pre-existing USLife customers.[58] (RX-17, p. 1). Respondent Fergus did not provide verbal notice of his PCO transactions to his employer.

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[57] Respondent Fergus joined USLife Equity and All American on the recommendation of Respondent Devine. (Tr. p. 250).

[58] Although Security Benefit's commission run showed that three of Respondent Fergus' customers canceled their annuities, none of the individuals was listed as a PCO customer. (CX-8, pp. 4-5).

The Hearing Panel also believes that future violations by Respondent Fergus, who has an otherwise unblemished record for more than ten years in the industry and has not repeated his misconduct since his move to LaSalle Securities, are unlikely. (Tr. 244). Respondent Fergus waited to solicit customers until after receiving Respondent Devine's report on the Denver meeting and Respondent Blake's reported conversation with Attorney FL.[59] (Tr. 242). Respondent Fergus solicited three customers for $132,950.15 and did not receive any commissions for his PCO sales.

Respondent Fergus determined the PCO promissory notes were insurance products based on his review of the PCO documents, but primarily on his confidence in, and conversations with, Respondent Blake and Respondent Devine.[60] Consequently, the Hearing Panel found that his actions were also more than simple negligence.

Accordingly, the Hearing Panel determined that an $8,000 fine and a 30 day suspension, rather than a bar, were appropriate. In addition, the Hearing Panel ordered Respondent Fergus to requalify by examination as an investment company and variable contracts products representative, based on a concern raised by Respondent Fergus' description of the selling away rule as "don't sell anything that is not on the approved product list" and his blind willingness to rely on his colleagues for his understanding of the rules. (Tr. 244).

## IV Conclusion

Therefore, based on the evidence submitted by the Department of Enforcement, the Hearing Panel: (1) fines Respondent Blake $35,000, suspends him for 90 days, and requires that he requalify

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[59] Respondent Fergus was not a knowing participant in the PCO fraud.

[60] Hair, 1993 WL 128737, *3 (1993) (a registered representative's reliance on informal discussions with colleagues, rather than an official opinion by appropriate firm personnel is not reasonable).

by examination as an investment company and variable contracts products representative; (2) fines Respondent Devine $34,825.42, suspends him for 45 days, and requires that he requalify by examination as an investment company and variable contracts products representative; and (3) fines Respondent Fergus $8,000, suspends him for 30-days, and requires that he requalify by examination as an investment company and variable contracts products representative. The Respondents are also ordered each Respondent to pay 1/3 of the $4,242.85 Hearing costs, which includes an administrative fee of $750 and hearing transcript costs of $3,492.85. These sanctions shall become effective on a date set by the Association, but not earlier than 30 days after the date this decision becomes the final disciplinary decision of the Association.[61]

**HEARING PANEL**

______________________________

By: Sharon Witherspoon
Hearing Officer

Dated: Washington, DC
June 13, 2000

Copies to:
Richard A. Blake (via Airborne Express and first class mail)
Frank T. Devine (via Airborne Express and first class mail)
Timothy J. Fergus (via Airborne Express and first class mail)
Stephen B. Diamond (via Airborne Express and first class mail)
David A. Genelly (via Airborne Express and first class mail)
Daniel P. Moakley (via electronic and first class mail)
Rory C. Flynn (via electronic and first class mail)

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[61] The Hearing Panel considered all of the arguments of the parties. They are rejected or sustained to the extent they are inconsistent or in accord with the views expressed herein.